AN UPDATE ON RECENT INSURANCE COVERAGE DECISIONS AND THEIR IMPACT ON THE CONSTRUCTION INDUSTRY:

THE POLICYHOLDERS' PERSPECTIVE

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October 1, 2015
Belo Mansion
Dallas, Texas

TABLE OF CONTENTS

I. *U.S. Metals, Inc. v. Liberty Mutual Group, Inc.*, No. 13-20433, 2014 WL 4652892 (5th Cir. Sept. 19, 2014)

Fresh off the heels of the Supreme Court issuing its decision on certified questions in *Ewing*, the U.S. Fifth Circuit Court of Appeals passed another case to the Supreme Court for review. *See U.S. Metals, Inc. v. Liberty Mutual Group, Inc.*, No. 13-20433, 2014 WL 4652892 (5th Cir. Sept. 19, 2014). The court's certified questions address two standard CGL exclusions—the "your product" exclusion and the "impaired property" exclusion.

A. Background

Exxon Mobil contracted with U.S. Metals to manufacture and sell to Exxon weld-neck flanges for refineries in Texas. *Id.* at *1. The flanges were "irreversibly incorporated" into certain facilities by welding and bolting the flanges into unit pipes that were insulated and buttoned up to "nonroad diesel" ("NRD") equipment. Exxon discovered a leak in one of the flanges during testing. Its subsequent investigation revealed that the flanges had been improperly manufactured. *Id.* As a result of the leaks, Exxon ordered new flanges from a different manufacturer and replaced all the flanges from U.S. Metals. In addition to the work that had to be done to remove and replace the flanges, the refineries had to be shut down for a period of time. *Id.*

Exxon filed suit against U.S. Metals, but Liberty Mutual had disclaimed coverage for the matter. *Id.* at *2. Thereafter, U.S. Metals settled with Exxon for nearly $6.5 million and then sought indemnification from Liberty Mutual, which again denied coverage. *Id.* Liberty Mutual's denial was premised on the "your product" and "impaired property" exclusions. *Id.* In the trial court, Liberty Mutual prevailed on summary judgment. U.S. Metals filed a timely appeal.

B. Certified Questions to the Supreme Court of Texas

According to the court, the issues before it turned on two questions of law that have not been directly addressed by the Supreme Court: (1) whether the terms "physical injury" and "replacement" found in the common "your product" and "impaired property" exclusions are ambiguous; and (2) if not, what do these terms mean pursuant to Texas law? *Id.* at *3. While the exclusions at issue are commonly found in CGL policies in Texas, the Fifth Circuit noted that the Supreme Court had not issued any decisions interpreting the language of the exclusions. *Id.* However, with regard to physical injury," the Fourteenth District Court of Appeals in Houston interpreting the meaning of that phrase in a similar "your property" exclusion. Liberty claims that the holding in that case means that the incorporation of a defective product into other property is not, standing alone, "physical injury." *Id.* at *4 (citing *Lennar Corp. v. Great Am. Ins. Co.*, 200 S.W.3d 651 (Tex. App.—Houston [14th Dist.] 2006, pet. denied)). But that court did not address whether damage to other integrated components would constitute "property damage." *Id.* And, on the other side of the line, the U.S. Seventh Circuit Court of Appeals held more than two decades ago that "physical injury" occurs at the moment of incorporation into

another product. *Id.* (citing *Eljer Mfg., Inc. v. Liberty Mut. Ins. Co.*, 972 F.2d 805, 807–14 (7th Cir. 1992) (applying Illinois law)[1]).

With regard to "replacement," a decision from the Southern District of Texas found that the term included the cost of tearing down other injured components even if the other components were "physically injured" on installation of the defective product. *Id.* (citing *Bldg. Specialties, Inc. v. Liberty Mut. Fire Ins. Co.*, 712 F. Supp. 2d 628, 641 (S.D. Tex. 2010)). And, in a prior Fifth Circuit decision, the court found the "impaired property" exclusion did not apply where the asphalt parking lot at issue could not be restored to use by "the repair, replacement, adjustment or removal" of the insured's defective excavation, backfilling and compacting work. *Id.* (citing *Fed. Mut. Ins. Co. v. Grapevine Excavation, Inc.*, 197 F.3d 720, 722 (5th Cir. 2000)). In Georgia, a federal district court found that damage to component parts during the repair and/or replacement of the faulty parts was excluded under the "impaired property" exclusion. *Id.* at *5 (citing *Gentry Mach. Works Inc. v. Harleysville Mut. Ins. Co.*, 621 F. Supp. 2d 1288, 1298 (M.D. Ga. 2008)).

Nevertheless, because none of the case law discussed included controlling Supreme Court case law, the Fifth Circuit certified the following four questions to the Court:

1. In the "your product" and "impaired property" exclusions, are the terms "physical injury" and/or "replacement" ambiguous?

2. If yes as to either, are the aforementioned interpretations offered by the insured reasonable and thus, must be applied pursuant to Texas law?

3. If the above question 1 is answered in the negative as to "physical injury," does "physical injury" occur to the third party's product that is irreversibly attached to the insured's product at the moment of incorporation of the insured's defective product or does "physical injury" only occur to the third party's product when there is an alteration in the color, shape, or appearance of the third party's product due to the insured's defective product that is irreversibly attached?

4. If the above question 1 is answered in the negative as to "replacement," does "replacement" of the insured's defective product irreversibly attached to a third party's product include the removal or destruction of the third party's product?

Id.

Commentary:

The forthcoming decision from the Supreme Court of Texas in *U.S. Metals* could prove to be a monumental one. For years, the common belief has been that Texas did not follow the

[1] Notably, the Illinois Supreme Court later criticized the Seventh Circuit's *Erie* guess. *See Travelers Ins. Co. v. Eljer Mfg., Inc.*, 757 N.E.2d 481 (Ill. 2001).

"incorporation" doctrine whereby the mere incorporation of a defective product into a larger product or structure is, in and of itself, "property damage." Moreover, the common belief has been that Texas did not allow for pure "rip and tear" costs unless it was necessary to rip and tear out work in order to access and repair otherwise covered "property damage." The answers to the foregoing certified questions should clarify where Texas truly stands on these issues.

II. *In re Deepwater Horizon*, No. 13-0670, 2015 WL 674744 (Tex. Feb. 13, 2015)

On February 13, 2015 the Supreme Court of Texas issued its much-anticipated decision in *In Re Deepwater Horizon*, which had been sent to the Court on certified questions from the U.S. Fifth Circuit Court of Appeals back in 2013. *See In re Deepwater Horizon*, No. 13-0670, 2015 WL 674744 (Tex. Feb. 13, 2015). The Court held that Transocean's insurance policies did not provide coverage for BP for the claims asserted against it arising out of the explosion and sinking of the *Deepwater Horizon* oil-drilling rig in the Gulf of Mexico. As explained in detail below (sorry, there simply is not a way to shortcut the Court's analysis), the Court reasoned that—under the facts presented—BP's coverage as an additional insured is limited by the specific terms of its contract with Transocean.

A. The Certified Questions

In 2013, the Fifth Circuit certified the following questions to the Court regarding BP's status as an additional insured:

> 1. Whether *Evanston Insurance Co. v. ATOFINA Petrochemicals, Inc.*, 256 S.W.3d 660 (Tex. 2008), compels a finding that BP is covered for the damages at issue, because the language of the umbrella policies alone determines the extent of BP's coverage as an additional insured if, and so long as, the additional insured and indemnity provisions of the Drilling Contract are "separate and independent"?
>
> 2. Whether the doctrine of *contra proferentem* applies to the interpretation of the insurance coverage provision of the Drilling Contract under the ATOFINA case, 256 S.W.3d at 668, given the facts of this case?

Ultimately, the Court held that, under the first question, BP was not covered by the policies for damages arising from subsurface pollution because BP, not Transocean, assumed liability for such claims. And because the court did not find any ambiguity in the policies, the second certified question was not addressed by the Court.

B. Background Facts

After the explosion and sinking of the drilling rig, both BP and Transocean sought coverage under Transocean's primary and excess insurance policies for the claims asserted against them. While not disputing that BP was an additional insured for some claims, Transocean and its insurers argued that the company was not an additional insured for liabilities it assumed in the Drilling Contract with Transocean. In particular, they claimed that BP was not an additional insured in connection with pollution-related liabilities arising from subsurface oil releases that occurred. In the Drilling Contract, Transocean agreed to indemnify BP for above-

surface pollution claims regardless of fault, and BP agreed to indemnify Transocean for all other pollution risk, including subsurface pollution.

Without limiting such obligations, Transocean also was required to carry multiple types of insurance, including a CGL policy with contractual liability coverage for the indemnity agreement of at least $10 million. BP and others were to be named "as additional insureds in each of [Transocean's] policies, except Workers' Compensation *for liabilities assumed by [Transocean] under the terms of [the Drilling] Contract*." *Id.* at *3 (emphasis added). Adhering to its contractual obligation, Transocean secured policies that extended "Insured" status to "[a]ny person or entity to whom the 'Insured' is obliged by oral or written 'Insured Contract' . . . to provide insurance such as afforded by [the] Policy," where "Insured Contract" meant "any written or oral contract or agreement entered into by the 'Insured' . . . and pertaining to business under which the 'Insured' assumes the tort liability of another party to pay for 'Bodily Injury' [or] 'Property Damage' . . . to a 'Third Party' or organization." *Id.*

With that information, the Court made the following conclusions: (1) BP is an additional insured under the Transocean policies for some purposes; (2) the Drilling Contract is an Insured Contract as defined by the insurance policies; and (3) the Insurers are not parties to the Drilling Contract. The central question, though, was whether and to what extent the policies incorporated terms of the Drilling Contract that may limit BP's additional insured status. In other words, the central issue was the interplay between the insurance policies and provisions in the Drilling Contract. The district court ruled against BP and, on appeal, the Fifth Circuit initially reversed that decision. *See In re Deepwater Horizon*, 710 F.3d 338 (5th Cir. 2013). On rehearing, however, the Fifth Circuit withdrew its opinion and certified the above questions to the Supreme Court. *See In re Deepwater Horizon*, 728 F.3d 491 (5th Cir. 2013).

C. The Arguments and Decision

BP argued to the Court that the decision in *ATOFINA* mandated that the existence and extent of coverage for BP be determined exclusively from the four corners of the insurance policies. The company claimed that the policy language was no different than language previously interpreted by the Supreme Court and others to be insufficient to import external limitations into the policies. On the other hand, Transocean and its insurers argued that BP's analysis fell short because it ignored the fact that BP only is an "Insured" by virtue of its status conferred by the Drilling Contract, to which the policies specifically refer by predicating additional insured coverage on the existence of an "Insured Contract." Such language, they argued, constituted an exception to the four-corners analysis. And, because BP's status as an "Insured" could not be ascertained without looking to the Drilling Contract, the language in that provision that limited the scope of such additional insured coverage had to be given its fair weight.

In addressing the parties' arguments, the Court discussed two of its prior holdings: *Urrutia v. Decker*, 992 S.W.2d 440 (Tex. 1999), and *ATOFINA*, 256 S.W.3d 660. In *Urrutia*, the Court held that an insurance policy incorporated a car rental agreement and that agreement, in turn, limited the customer's liability protection to $20,000. In *ATOFINA*, on the other hand, the insurance policy had two coverage provisions—one of them was tied to the terms of another agreement, but the second was tied only to the terms of the policy itself. Because the one

provision was not tied to the service contract at issue, there was no need to look at that document to ascertain ATOFINA's status as an additional insured; rather, all that was necessary was to satisfy the terms of the policy. The Court, in construing *ATOFINA* and other cases, determined that:

> [W]hile our inquiry must begin with the language in an insurance policy, it does not necessarily end there. In other words, we determine the scope of coverage from the language employed in the insurance policy, and if the policy directs us elsewhere, we will refer to an incorporated document to the extent required by the policy. Unless obligated to do so by the terms of the policy, however, we do not consider coverage limitations in underlying transactional documents.

In re Deepwater Horizon, 2015 WL 674744 at *5. In the instant case, unlike in *ATOFINA*, the Transocean policies required reference to the Drilling Contract to determine BP's status as an additional insured because those policies did not specifically name BP as such. Thus, in line with the decision in *ATOFINA*, the Court noted that it would "rely on the policy's language in determining the extent to which, if any, [the Court] must look to an underlying service contract to ascertain the existence and scope of additional-insured coverage." *Id.* at *7. Also, the Court found that two other cases relied on by BP actually affirmed "the principle that we must consider the terms of an underlying contract to the extent the policy language directs us to do so." *See Aubris Resources LP v. St. Paul Fire & Marine Ins. Co.*, 566 F.3d 483 (5th Cir. 2009); *Pasadena Refining System, Inc. v. McRaven*, 2012 WL 1693697 (Tex. App.—Houston [14th Dist.] May 15, 2012, pet. dism'd by agr.); *see also Urrutia*, 992 S.W.2d at 442.

Applying the foregoing, the Court concluded that BP was an additional insured only as to liabilities specifically assumed by Transocean under the Drilling Contract. And, because Transocean did not assume liability for subsurface pollution claims, Transocean had no obligation to obtain additional insured coverage for BP for that risk. Therefore, BP was not an additional insured for that risk.

In closing, the Court also rejected BP's claim that the additional insured clause in the policies could not limit the scope of its coverage based on the indemnity agreements because the insurance and indemnity agreements in the Drilling Contract were separate and independent. The Court explained that Transocean's insurers did not owe any obligation to BP except as stated in Exhibit C of the parties' contract, so while a separate article of the Contract could be read as saying the insurers' indemnity obligation was not limited by the requirements in Exhibit C, the indemnity obligation to BP would not arise in the first place except on the conditions stated in that Exhibit. Moreover, while indemnity and insurance may be separate, that does not prevent them from being *congruent*; therefore, "a contract may reasonably be construed as extending the insured's additional-insured status only to the extent of the risk the insured agreed to assume," which was the case before the Court. *In re Deepwater Horizon*, 2015 WL 674744 at *12.

Based on the foregoing analysis, the Court answered the first certified question in the negative "because BP is not covered for the damages at issue by virtue of the limitations on the scope of its additional-insured status imposed in the Drilling Contract and incorporated into the Transocean insurance policies by reference." *Id.* Having answered in that manner, the Court noted that the second certified question need not be addressed, as the ambiguity rule only applies

if there is more than one reasonable interpretation of an insurance policy and the Court found that that was not the situation before it.

D. The Dissent

Justice Johnson issued a dissent, noting that he did not disagree with the Court's recitation of the principles applicable to construing insurance contracts, but he did disagree with how they were applied by the Court. *Id.* at *13 *et seq*. He looked to the policy language wherein the Insurers agreed that "where required by written contract, bid or work order, additional insureds are automatically included hereunder, and/or waiver(s) of subrogation are provided as may be required by contract," and argued that the phrase "as may be required by contract" applied only to waivers of subrogation and not to additional insureds. He also noted that neither the definition of "Insured" nor the definition of "Insured Contract" limited the terms of additional insured coverage to the scope of the obligation assumed by the "Insured" in that "Insured Contract." Justice Johnson also compared the original policy language that restricted additional insured coverage to that which was no broader than provided under the underlying policies to the language provided by an endorsement that extended additional insured status to any person or organization included as an additional insured under the underlying policies. He further noted that, based on such comparison, the insurers knew how to restrict additional insured coverage to parties covered because of a collateral agreement and chose not to do so here.

Ultimately, Justice Johnson argued that, like in *ATOFINA*, the Court should have determined the scope of coverage based solely on the terms of the policy and not the collateral indemnity agreement. He disagreed with the Court's holding for several reasons, including the fact that the Drilling Contract's language was not explicitly incorporated into the policies and was not deemed incorporated as the policies provided for other documents that were intended to be part of the policies. Further, Justice Johnson urged that nothing in the policies or Drilling Contract precluded BP from having broader additional insured coverage than Transocean agreed to provide, so BP was an Insured for whom coverage extended for "liability (a) imposed upon [BP] by law or (b) assumed by [Transocean] under [the drilling contract]." And, finally, even if BP's status as an additional insured was limited, BP also qualified as an "Insured," which afforded BP full coverage. *Id.* at *15–*16.

Commentary

The Supreme Court's decision in *In re Deepwater Horizon* makes clear that a distinction exists between contracts whose indemnity and insurance provisions are separate and independent and those whose provisions are inextricably intertwined. In the former scenario, the Court's prior decision in *ATOFINA* remains alive and well. However, when the provisions are inextricably intertwined as was the case before the Court, Texas courts will be required to look at the terms of the incorporated contract to determine the scope of coverage available to an additional insured. If additional insureds want to avoid resort to extrinsic documents, they will need to make sure that the additional insured provisions stand on their own and do not refer back to (and, therefore, incorporate) contractual limitations.

Just as importantly, because the Court did not reach the second certified question, an issue remains in Texas as to whether there should be a "sophisticated insured" exception to the

contra proferentum doctrine. As it stands, a split remains between two federal district courts on this issue, so it remains to be seen whether ambiguous provisions should be construed in favor of coverage—at least when the insured is deemed to be a sophisticated party.

Quick Update

On June 10, 2015, the U.S. Fifth Circuit Court of Appeals issued a decision relying on the holding of *In re Deepwater Horizon*. *See Ironshore Specialty Ins. Co. v. Aspen Underwriting, Ltd.*, 788 F.3d 456 (5th Cir. 2015). The issue before the court was whether the terms of a Master Service Agreement between two parties limited an additional insured to only $5 million in coverage under the other parties' policies instead of being entitled to coverage up to the full $51 million in limits that was available to the named insured. Relying in large part on the decision in *In re Deepwater Horizon*, the Fifth Circuit determined that the insurance policy at issue limited the insurers' obligations to the $5 million their named insured was "obliged" to provide under the terms of the MSA. Put differently, the court found that the Supreme Court of Texas's decision in *In re Deepwater Horizon* was not dependent on the fact that the insurance policy at issue in that case included both (a) an "Insured Contract" provision,[2] and (b) a "where required" provision.[3] Rather, relying on both the majority and dissenting opinions, the court concluded that the "Insured Contract" provision was a sufficient ground in *Deepwater Horizon* to incorporate the Drilling Contract's limitation on coverage for above-surface pollution. Because the language in the policy before it was "nearly identical" it "compel[led] the same result." *Id.* at 463. Thus, coverage was limited to $5 million as set forth in the parties' MSA.

III. *Companion Property & Casualty Insurance Co. v. Opheim*, No. 3:14-CV-0752-G, 2015 WL 731246 (N.D. Tex. Feb. 20, 2015)

Addressing the duty to indemnify, the Northern District of Texas ruled that the insurer was not entitled to summary judgment on a late notice defense because the insurer failed to prove prejudice existed as a matter of law. *See Companion Prop. & Cas. Ins. Co. v. Opheim*, No. 3:14-CV-0752-G, 2015 WL 731246 (N.D. Tex. Feb. 20, 2015). In addition, the court rejected any application of exclusions j.(5) and j.(6), but the court did find that the policy's roofing exclusion applied to negate coverage for flooding damage suffered by the underlying claimant.

A. Background

This insurance dispute arose out of an earlier state court judgment against the insured, a homebuilder, and awarded to Charles Opheim, the homeowner. Opheim had hired Kevin Dillingham and his company, Constructure, to add a second story to Opheim's home. The initial plan was to perform the construction in phases so that Opheim could remain living in the home. However, at some point, one of the subcontractors removed the roof of the home, creating a

[2] This provision stated that "Insured" included "any person or entity to whom the 'Insured' is obliged by oral or written 'Insured Contract' . . . to provide insurance such as is afforded by this Policy." *In re Deepwater Horizon*, 2015 WL 674744 at *3.

[3] This provision stated as follows: "Underwriters agree where required by written contract, bid or work order, additional insureds are automatically included hereunder, and/or waiver(s) of subrogation are provided as may be required by contract." *Id.*

funnel effect that directed rain water into that portion of the home in which Opheim intended to live. The flooding forced Opheim to leave the home during construction and additional problems in the ensuing months led Dillingham to abandon the project. *Id.* at *1.

The parties' claims against one another ultimately were sent to arbitration. During a deposition, Dillingham admitted that he had not turned the claim over to his insurer. Accordingly, Opheim put Companion on notice directly by notifying its agent for claims handling, Dallas National Insurance Company. While Opheim initially corresponded directly with DNIC, the insurer's adjuster expressed a desire to communicate with Opheim's attorney instead. Correspondence from Opheim's counsel to DNIC's representative, however, went unanswered. Dillingham ultimately confirmed that the arbitration was pending, but when it was requested that he forward the arbitration papers and other information necessary for the insurer's investigation, he failed to do so. Opheim's counsel's letters to Dillingham's counsel imploring Dillingham to make a claim on his policy were ignored. Dillingham never sought or requested a defense from Companion. *Id.* at *1–*2.

Ultimately, in the arbitration, the arbitrator concluded that Dillingham breached its contract and violated the DTPA. Accordingly, the arbitrator awarded damages and attorneys' fees to Opheim. Before the award was confirmed by a Dallas court, Dillingham finally contacted Dallas National to file a claim. Two years later, Companion filed a complaint for declaratory relief against all the underlying parties. Eventually, Companion filed a motion for summary judgment with the court. *Id.* at *2.

B. The Court's Decisions

After addressing some evidentiary issues, the court turned to the determination of Companion's duty to indemnify Dillingham for the arbitration award entered against him. First, the court addressed a roofing exclusion in the policy that barred coverage for "property damage" claims "arising out of . . . Any Roofing or Any Plumbing Excluding Swimming Pools and Exterior Spas . . . , regardless of whether such operations are conducted by you or on your behalf or whether the operations are conducted for yourself or for others." *Id.* at 12. Using the ordinary meanings of roofing and operations, Opheim argued that "roofing operations" means the "performance of the act of covering with a roof." Because the exclusion precluded coverage for damage "arising out of" roofing operations, which requires only a "causal connection or relation," the court said that the roofing exclusion would preclude coverage for the flooding damage if it was "causally connected or related" to the "performance of the act of covering with a roof." *Id.* at *13.

Opheim sought to discredit such a meaning of "arising out of," claiming that applying such an interpretation to the policy before the court "would exclude coverage for all property damage that might take place on the premises." *Id.* The court disagreed, however, noting that, while in some cases a broad interpretation of "arising out of" will be inconsistent with the parties' intent, "Courts decide disputes on the facts presented to them, not on any conceivable set of facts that could justify an alternative conclusion." *Id.* Looking at the actual facts before it, as is required for determining the duty to indemnify, the court rejected Opheim's attempt to characterize the operations as "demolition," as it did not address what the subcontractor demolished—i.e., the roof. Simply put, the evidence before the court was clear that the flooding

damages were, at a minimum, causally related to the roofing operations because those operations led to the funnel effect that caused the flooding damages. *Id.* at *14.

Notably, the court briefly addressed exclusions j.(5) and j.(6). Despite the fact that the court acknowledged that, aside from flooding damage, other additional problems occurred during the renovation project and months before the insured abandoned the construction, the court found that exclusion j.(5) could not apply because it only "applies while operations are being performed." And, with respect to j.(6), the court found as follows: "[O]nce Dillingham abandoned the project, the 'products-completed operations hazard' reinstated coverage for 'property damage' arising from 'your work' that occurs 'away from premises you own or rent.' [citation omitted]. All of the damages from the underlying judgment fall under the 'products-completed operations hazard,' nullifying the j(6) exclusion's impact." *Id.* The court did not elaborate on the evidence presented as to the timing of the damages but suggested by its decision that they occurred post-completion.[4]

Additionally, the court addressed Companion's late notice defense. Although the insured did not put the insurer formally on notice until after the arbitration award was issued, but before it was confirmed by a state court judge, the court found that Companion failed to establish prejudice as a matter of law. In doing so, the court noted the following:

> (1) Opheim notified Dallas National, Companion's agent, of the dispute prior to the arbitration proceeding; (2) Dallas National failed to communicate with Opheim, or his attorneys, until after the arbitration award was confirmed by a final judgment; and (3) the damages result not from a default judgment but from an arbitration proceeding confirmed through a final judgment.

Id. As such, the court found that a genuine fact issue existed that precluded summary judgment on the issue.

Finally, the court also addressed the issue of allocation of damages between covered and uncovered claims. Because the arbitrator did not consider the roofing exclusion in the insured's policy, his lump sum award provided no insight into the apportionment question. As such, the court found that a jury should address the allocation issue based on the evidence presented, including a property inspection report and an estimate to repair defects at the residence. *Id.*

Commentary:

Although the discussion was brief, the court's holding regarding prejudice on the insurer's late notice defense likely is the most interesting and important aspect of the decision. Although Texas case law is clear that an underlying claimant cannot put an insurer on notice of a claim on behalf of the insured defendant, the court relied exclusively on the claimant's communications with the insurer (or lack thereof) in finding that a fact issue existed as to whether prejudice existed to support the late notice defense. Because putting the insurer on

[4] If that were the case, and the damages did occur after the insured abandoned the project, it is curious that no mention was made of the "your work" exclusion, which applies to damages in the "products-completed operations hazard." Although not mentioned, perhaps the insured utilized subcontractors, triggering the "subcontractor exception" to that exclusion and rendering the exclusion irrelevant.

notice of a claim or suit typically is the insured's obligation, the court's focus on the underlying claimant's conduct—and the insurer's response to same—is peculiar. Similarly, the court's systematic rejection of the applicability of exclusions of j.(5) and j.(6) without addressing the types of damage at issue and the timing of such damage is not consistent with Texas precedent on the issue. Notably, the mere fact that the project was abandoned does not mean that exclusions j.(5) and j.(6) can have no application if the damage occurred prior to the abandonment. That being said, the court's analysis of the roofing exclusion was thorough and ultimately correct. While "roofing operations" may mean the performance of the act of covering with a roof, the removal of a roof is causally related to such operations and, therefore, the court correctly concluded that coverage should not exist for those damages.

IV. *Dallas National Insurance Co. v. Calitex Corp.*, 458 S.W.3d 210 (Tex. App.—Dallas 2015, no pet.)

In another duty to indemnify case, the Dallas Court of Appeals reversed and rendered a trial court's decision, finding in favor of the insurer. *See Dallas Nat'l Ins. Co. v. Calitex Corp.*, 458 S.W.3d 210 (Tex. App.—Dallas 2015, no pet.). In reaching its conclusions, the court found that exclusion j.(5) applied to negate some of the damages at issue and the insured's failure to properly allocate its damages between covered and uncovered claims barred any coverage under the policy.

A. Background

The insured, Turnkey Residential Group, Inc. ("Turnkey") agreed to construct a twelve-unit townhome complex in Dallas. Calitex, the owner of the project, ultimately filed suit against Turnkey, claiming that

> (1) "the stone exterior . . . was not properly treated, leaked, or entire areas were left uncovered with stone (a problem that still exists)" and (2) "windows, once installed, leaked." Further, Calitex asserted in its petition (1) "[a]s of February 10, 2008, over half of the Project units had not reached substantial completion and were not ready for use and/or occupancy" and (2) "[t]oday the Project is substantially complete," but "the quality of materials, labor and craftsmanship do not satisfy the standards required of Defendants under the [c]ontract" and have resulted in "damages."

Id. at 214. When Turnkey tendered the lawsuit to its insurer, Dallas National, the insurer responded that it had no duty to defend or indemnify Turnkey under the terms of its policy. Left without a defense, the insured proceeded to trial where a judgment was entered against it and in favor of Calitex. Calitex then filed suit against Dallas National.

Moving for summary judgment, Dallas National claimed that the damages were not covered damages, exclusion j.(5) applied to negate coverage, and no allocation was made between covered and non-covered damages. Calitex responded that the exclusion did not apply because the damages did not occur during ongoing operations and no evidence in the record existed that the damages at issue were discovered during "ongoing operations" by Turnkey or its

subcontractors. Further, because such damages were not excluded, Calitex argued that allocation was not required.

B. Exclusion J.(5) Applies to Negate Coverage

Addressing the insurer's argument that exclusion j.(5) applied to negate coverage, the court noted that exclusion j.(5) states that the policy does not apply to "property damage" to "[t]hat particular part of real property on which you or any contractors or subcontractors working directly or indirectly on your behalf are performing operations, if the 'property damage' arises out of those operations." The court emphasized that prior Texas courts have held that the present tense "are performing operations" "makes clear that the exclusion only applies to property damage that occurred during the performance of construction operations." *Id.* at 224. Moreover, to the extent the claimant contended that the exclusion should not be applicable because the damage was not "discovered" until after Turnkey was no longer performing operations, Calitex failed to explain how "discovery" was relevant. *Id.* at 224–25 (citing *Don's Bldg. Supply, Inc. v. OneBeacon Ins. Co.*, 267 S.W.3d 24, 25 (Tex. 2008)). In fact, the evidence presented by the insurer—evidence specifically relied on by Calitex in support of the underlying litigation—made clear that problems began and damages resulted during construction, including leaks when construction was "80 percent or 90 percent complete" and leaks in a third of the units in August (i.e., during construction). *Id.* at 225. Thus, the court concluded that at least some of the damage established by Calitex in the underlying lawsuit was to "that particular part of real property" on which Turnkey or its subcontractors "were performing operations" and such damage arose out of those operations. *Id.*

C. Allocation of Damages

Having found the exclusion applied, at least in part, the court turned to the insurer's argument that Calitex had the burden to allocate its damages between covered and uncovered loss and its failure to do so meant that no damages could be awarded. Calitex responded with two arguments: (1) the obligation to allocate does not exist when all the damages are covered by the policy; and (2) requiring the claimant to go behind the judgment and allocate damages "is tantamount to a collateral attack on the [underlying judgment] and should be rejected." *Id.* at 225–26. The court rejected Calitex's misplaced reliance on decisions in *Employers Casualty Co. v. Block*, 744 S.W.2d 940, 943 (Tex. 1988), and *Evanston Insurance Co. v. ATOFINA Petrochemicals, Inc.*, 256 S.W.3d 660, 672 (Tex. 2008). Both of those decisions were clear that, while an insurer could not challenge the reasonableness of a settlement, an insurer could challenge whether *coverage* existed for the settlement. Further, Calitex's claim that DNIC's allocation argument was a "collateral attack" simply failed. Calitex presented no evidence of how a coverage determination in the instant case would have any impact on the liability established in the underlying litigation. Despite having the burden to allocate its damages, the court found that Calitex failed to do so, as there was "no reasonable basis" in the record "for estimating the amount of damage or the proportionate part of damage caused by a risk covered by the insurance policy." *Id.* at 227 (citation omitted). Calitex's failure to segregate was fatal to its recovery.

Commentary:

The decision in *Calitex* is fairly routine with respect to the court's finding that exclusion j.(5) applied to negate at least some of the damages awarded to the claimant in the underlying arbitration. However, the court's subsequent discussion of the claimant's (and also the insured's) obligation to allocate damages between covered and uncovered claims is an important reminder of the obligation an insured faces if an insurer correctly determines that an exclusion applies to some portion of the damages at issue. Ultimately, the insured (or in a third-party judgment creditor scenario, the underlying claimant) will be responsible for presenting evidence sufficient for a court to allocate damages between covered and uncovered loss. As noted by the court, the inability to do so simply is fatal to any recovery under a CGL policy.

V. *Amerisure Mutual Insurance Co. v. Arch Specialty Insurance Co.*, 784 F.3d 270 (5th Cir. 2015)

On April 21, 2015, the Fifth Circuit Court of Appeals issued an important decision pertaining to the "Supplementary Payments" provision found in standard CGL policies. *See Amerisure Mutual Insurance Co. v. Arch Specialty Insurance Co.*, 784 F.3d 270 (5th Cir. 2015). At issue was a dispute between a CGL insurer and an insurer of an Owner Controlled Insurance Program ("OCIP") over which the CGL insurer claimed to be excess.

A. Background

Arch issued an OCIP policy to Endeavor Highrise, LP that covered endeavor, as well as its contractors and subcontractors (including Admiral Glass & Mirror) for bodily injury and property damage claims. Separately, Admiral was insured under its own CGL policy issued by Amerisure. The Arch policy included a standard "Supplementary Payments" provision that provided that Arch would pay "[a]ll expenses we incur" in connection with a covered claim, but Endorsement 16 of that policy expressly deleted and replaced that provision with "[supplementary payments] will reduce the limits of insurance," which were $2 million per occurrence and in the aggregate. The duty to defend under the OCIP policy was stated to end when the insured had used the applicable limits of insurance "in the payment of judgments or settlements." *Id.* at 272.

Prior to the claim giving rise to the instant lawsuit, Arch settled three claims. One of the claims was settled for $1,555,000.00 under the general aggregate insurance limit, while the other two were settled for a combined $1,472,032.61 under the completed operations aggregate limit. Arch incurred defense costs in each of the three lawsuits. *Id.*

Ultimately, Endeavor filed suit against Admiral and others, and Admiral's insurer tendered the claim to Arch for a defense and indemnity. While Arch ultimately accepted the defense, it did not do so until after Amerisure incurred more than $20,000 in attorney's fees. Moreover, subsequently, Arch withdrew its defense, claiming that its combination of indemnity payments and defense fees exhausted the pertinent $2 million limit of insurance. After the denial, Amerisure controlled the defense and settled the case on behalf of Admiral. Amerisure then filed suit against Arch, claiming that Arch wrongfully refused to defend and indemnify Admiral.

On cross-motions for summary judgment, the magistrate judge determined the following: "(1) defense costs and attorneys' fees were 'expenses' under the Supplementary Payments provision and therefore eroded the policy limits; (2) though subject to the same policy limits, the duty to defend ended only when the policy limits were exhausted by judgments and settlements alone (i.e., not by defense costs); and (3) coverage existed for the toilet and sprinkler leaks and therefore Arch did not 'wrongfully exhaust' the policy limits with payments on uncovered claims." *Id.* The district court adopted the magistrate's recommendation over both parties' objections and held that Arch did not breach its duty to indemnify, but did breach its duty to defend Admiral. Both parties appealed.

B. Supplementary Payments and Defense Costs as "Expenses"

At the outset, the Fifth Circuit addressed the "Supplementary Payments" provision and whether defense costs were "expenses." Amerisure claimed that they were not and, even if they were, the statement in that provision that the remainder of the policy remained unchanged had to be read together with the duty to defend language that the duty expires when "we have used up the [policy limits] in the payment of judgments or settlements." *Id.* at 274. Arch, on the other hand, argued that "expenses" did include defense costs and that the Endorsement at issue converted the policy to an eroding policy. *Id.* The court agreed with Arch. In doing so, the court noted that the term "expenses" is not defined in the policy and, therefore, it was given its ordinary meaning. Under Texas law, in numerous contexts, "expenses" has been known to include attorneys' fees. *Id.* (citations omitted). Absent an indication of a different meaning for the term, the court opted to adopt the common meaning of the term.

Having made that determination, the court turned to Arch's argument that the endorsement made the policy an eroding policy. Arch's argument was that, under Texas law, an endorsement governs over general policy language. Again, the court agreed. In doing so, the district court rejected the magistrate judge's recommendation that the endorsement created to policy limits: "one for the indemnity obligation, which is satisfied by payment of settlements, judgments, and 'supplementary payments' including defense costs, and one for the defense obligation, which is satisfied only by payment of settlements and judgments." *Id.* at 275. The court found that to not be a reasonable construction of the policy because it read out the terms of the endorsement entirely.

Commentary:

This decision from the Fifth Circuit Court of Appeals emphasizes the importance of endorsements to an insurance policy. At bottom, a specific endorsement trumps general policy language. Thus, here, the court found that an endorsement regarding supplementary payments converted a "normal" CGL policy to an eroding policy. In doing so, the payment of defense costs reduced the limit of insurance available to pay indemnity claims. As such, a policy that traditionally would have been excess of a full $2 million in indemnity payments effectively had its attachment point lowered to the extent defense costs were paid in connection with covered claims under the policy. While standard CGL policies will not have such endorsements, it is important to review all policy provisions and endorsements to ensure that such endorsements do not change the substance of the coverage available to an insured.

VI. *Gulf Coast Environmental Systems, LLC v. American Safety Indemnity Co.*, No. 4:13-CV-539, — WL — (S.D. Tex. Apr. 21, 2015), *report and recommendation adopted by* 2015 WL 3648859 (S.D. Tex. June 11, 2015)

On June 11, 2015, Judge Keith Ellison adopted the report and recommendation of then-Magistrate Judge George Hanks, Jr., which was a sweeping decision regarding an insurer's duty to defend. *See Gulf Coast Environmental Sys., LLC v. Am. Safety Indem. Co.*, No. 4:13-CV-539, — WL — (S.D. Tex. Apr. 21, 2015), *report and recommendation adopted by* 2015 WL 3648859 (S.D. Tex. June 11, 2015). Because the Magistrate Judge's opinion addressed the duty to defend in a thorough manner, that decision is highlighted here. As noted, over ASI's objections, the District Court adopted the report and recommendation.

A. Background Facts

Gulf Coast sought a defense and indemnity from ASI for a lawsuit against it in Pennsylvania. Gulf Coast had been hired by Piramal Critical Care, Inc. ("Piramal") to "manufacture, deliver, and install a regenerative thermal oxidizer system ('RTO')." Slip op. at 2. The RTO was installed and "went on-line" on February 26, 2010, but Piramal alleged that it never worked properly. One of the many alleged problems was a "scrubber" made by Gulf Coast's subcontractor, Delta Cooling Towers, which purportedly "flooded and damaged other parts of the RTO." *Id.* at 3.

ASI issued a CGL policy and an Excess policy to Gulf Coast. The CGL policy included both Coverage A ("Bodily Injury and Property Damage Liability") and Coverage D ("Environmental Consultant's Professional Liability").[5] The parties agreed that the Excess policy did not apply until the CGL policy was exhausted. While the Piramal suit against Gulf Coast remained pending, Gulf Coast filed suit against ASI. The parties ultimately filed cross-motions for summary judgment.

B. The "Contractual Liability" Exclusion

After addressing the confines of the "eight corners" rule and Texas's rules of contract interpretation, the court turned to the exclusions on which ASI relied to dispute coverage.[6] As noted by the court, the "contractual liability" exclusion had been the subject of numerous opinions recently. *Id.* at 12 (citing *Gilbert Tex. Constr., L.P. v. Underwriters at Lloyd's London*, 327 S.W.3d 118 (Tex. 2010)). That exclusion negates coverage for "'property damage' for which the insured is obligated to pay damages by reason of the assumption of liability in a contract or agreement." *Id.* The court explained that, in *Gilbert*, Gilbert's promise to DART that it would repair or pay for damage to any third party property caused by Gilbert's failure to comply with its contractual requirements extended "beyond Gilbert's obligations under general law." *Id.* at 13 (quoting *Gilbert*, 327 S.W.3d at 127). The court also found that the exception to the exclusion for liability that "the insured would have in the absence of the contract or agreement" did not apply,

[5] Ultimately, because the court finds that a duty to defend exists under Coverage A, it does not address the substantive arguments of ASI pertaining to Coverage D.

[6] The parties' presumably agreed that the insuring agreement had been satisfied, and, therefore, the court did not address the "property damage" and "occurrence" requirements.

noting the "unusual circumstances" of that case. *Id.* at 13–14. That decision was later addressed in *Ewing Construction Co. v. Amerisure Mutual Insurance Co.*, 420 S.W.3d 30 (Tex. 2014), where the Supreme Court of Texas held that the exclusion did not apply where the insured agreed to perform its work in a good and workmanlike manner. Simply put, the contractor had not "enlarge[d] its duty to exercise ordinary care in fulfilling its contract," and had not "'assume[d] liability' for damages arising out of its defective work so as to trigger the Contractual Liability Exclusion." *Gulf Coast*, slip op. at 15 (citing *Ewing*, 420 S.W.3d at 38). Finally, the Fifth Circuit followed suit in *Crownover v. Mid-Continent Casualty Co.*, 772 F.3d 197 (5th Cir. 2014), finding that an express duty to repair in an insured's contract with homeowners was no different than its duty to perform its work with reasonable care; thus, the duty to repair did not exceed the insured's common law obligations. *See Gulf Coast*, slip op. at 15–16 (discussing *Crownover*).

Turning to the facts before it, the court noted that ASI argued that, even under *Ewing* and *Crownover*, the contractual liability exclusion applied because Piramal's allegations against Gulf Coast "go beyond common law obligations . . . Gulf Coast agreed to adhere to very specific building standards, emission requirements and deadlines and Piramal seeks damages in the underlying suit for Gulf Coast's allege[d] failure to satisfy those contractual requirements." *Id.* at 16–17. The court disagreed, however, finding that the insurer had a duty to defend so long as a single claim potentially was covered by the policy. *Id.* at 18 (citing cases). Applying the logic of the cases before it, the court found that at least some of Piramal's claims were not excluded by the "contractual liability" exclusion. *Id.* at 19 (noting for example, claims that Gulf Coast breached its contract by failing to perform services "in a professional manner" or failing to "exercise reasonable care in the engineering, design, manufacturing, delivery, installation and commission for the RTO and scrubber"). Thus, the exclusion did not negate ASI's duty to defend.

C. Exclusion J.(6)

Next the court looked to exclusion j.(6), which bars coverage for "property damage" to "[t]hat particular part of any property that must be restored, repaired or replaced because 'your work' was incorrectly performed on it." *Id.* at 20. An exception to the exclusion states that the exclusion does not apply to "property damage" in the "products-completed operations hazard." *Id.* ASI argued that the exclusion applied because Gulf Coast was contractually required to successfully run the system for 30 days but Piramal alleges that the system never was "successfully commissioned" and, therefore, the alleged damage occurred during ongoing operations. *Id.* at 21–22.

The court reviewed the case law relied on by ASI, finding none of them to be on point because they either did not address the exception to exclusion j.(6) or did not address exclusion j.(6) at all. *Id.* at 22–23 (discussing *Admiral Ins. Co. v. Little Big Inch Pipeline Co., Inc.*, 523 F. Supp. 2d 524 (W.D. Tex. 2007); *Jim Johnson Homes v. Mid-Continent Cas. Co.*, 244 F. Supp. 2d 706 (N.D. Tex. 2003); *Duininck Bros., Inc. v. Howe Precast, Inc.*, No. 4:06-CV-441, 2008 WL 4372709 (E.D. Tex. Sept. 19, 2008)). Noting cases on point and the policy language, the court found the exception applied. According to the court, the exception means that the exclusion does not apply to property damage occurring after Gulf Coast's work was finished or abandoned. *Id.* at 23–24 (citing *Crownover*, 772 F.3d at 213 (analyzing exclusion j.(6) and the "products-

completed operations hazard" exception, noting "Mid-Continent acknowledges that [exclusion j.(6)] applies only to property damage that occurred while work was ongoing, not damage to completed work")). The court explained that Piramal alleged that the parties' contract required Gulf Coast to design, manufacture, install and commission a RTO and scrubber system. ASI contends that the allegations can be read that the first three were complete, but the commissioning never was finished and, thus, the exception to the exclusion does not apply. *Id.* at 24. Recognizing that the issue before the court was the duty to defend, the court construed the pleadings liberally, finding that the allegations could be "read as separate, independent claims arising from Gulf Coast's design of the RTO, manufacturing of the RTO, installation of the RTO and scrubber and commissioning of the RTO." *Id.* And, while other courts have reached different conclusions on the exception, they did so on different facts and, more importantly, involved the duty to indemnify as opposed to the duty to defend. *Id.* at 25 (collecting cases). At the end of the day, a fair reading of the allegations was that designing, manufacturing and installing the RTO and scrubber had been completed, albeit unsatisfactorily, as the RTO was placed on-line and performed its purpose of clearing contaminants but did not meet the required efficiency rating. *Id.* at 25–26. The court noted: "For defense coverage purposes, if the pleading against the insured alleges that the insured never 'completed' its work at the project, that still leaves open the possibility that the insured abandoned the work, such that the situation cold still qualify under the definition of 'products-completed operations hazard,' such that this exclusion cannot be sued to deny defense coverage." *Id.* at 26 (quoting SCOTT TURNER, INSURANCE COVERAGE OF CONSTRUCTION DISPUTES § 32:5 (2d ed. 2013)). Because at least one claim could be potentially covered, the duty to defend was not negated by exclusion j.(6).

D. The "Your Product" and "Your Work" Exclusions

The parties' dispute then centered on the "your product" and "your work" exclusions, which, by their plain terms, preclude damage to the insured's work or product if such damage arises out of the work or product. Gulf Coast claimed that a "Limited Products Liability Coverage Endorsement" added specific coverage for thermal oxidizers like the RTO and, therefore, the exclusions could not apply. ASI countered that that endorsement only includes "bodily injury" coverage. Gulf Coast countered that the "your work" exclusion could not apply by virtue of the applicability of the subcontractor exception to that exclusion because Piramal alleged that some of the damages were caused by Gulf Coast's subcontractor, Delta. *Id.* at 27–28.

Again noting the bedrock principles of the duty to defend, the court construed the underlying allegations liberally and in favor of coverage. In particular, Piramal sought damages for "all consequential damages as a result of Gulf Coast's failed performance," as well as damages caused when "the Delta scrubber system flooded and damaged other parts of the RTO." Relying on the decision in *Lexington Insurance Co. v. National Oilwell NOV, Inc.*, 355 S.W.3d 205, 213 (Tex. App.—Houston [1st Dist.] 2011, no pet.), the court found that the allegations at least potentially alleged property damage (including loss of use under prong two of the definition of "property damage") to something other than Gulf Coast's work or products and that at least a portion of such damages was caused by Gulf Coast's subcontractor. Thus, those exclusions could not operate to negate the duty to defend.

E. The "Impaired Property" Exclusion

To the extent Piramal sought damages for the loss of use of its factory, ASI argued that the factory was "impaired property" damage to which was excluded from coverage by the "impaired property" exclusion. The court, however, agreed with Gulf Coast that the allegations of flooding of the scrubber and RTO satisfied the "sudden and accidental physical injury" exception to that exclusion. Further, the court held that the allegations constituted "physical injury to tangible property" and not merely loss of use—"to the contrary, it is at least potentially, if not plainly, an allegation of physical injury to Piramal's property as well as an allegation of sudden and accidental physical injury to Gulf Coast's RTO and scrubber." *Id.* (citations omitted). Accordingly, the exclusion did not apply and ASI had a duty to defend.[7]

F. When Did the Duty to Defend Begin?

Finally, the court determined that the duty to defend began with the tender of the Original Complaint by Piramal against Gulf Coast. Although that Complaint did not include the allegation of flooding of the RTO by the scrubber, the court still found the allegations were sufficient to trigger the duty to defend. "The Original Complaint alleges that the RTO did not function properly and that Piramal thereby suffered damages including the loss of use of its factory and 'other consequential damages.'" *Id.* at 34. Again reading the allegations broadly for the purpose of the duty to defend, the court found that such allegations did not rule out the possibility of covered damages to Piramal's facility beyond the RTO and scrubber or that the loss of use of the factory was the result of a sudden and accidental physical injury. As such, the duty to defend arose under the Original Complaint.

G. Adoption of the Report and Recommendation

As noted, Judge Ellison adopted the report and recommendation over the objections of ASI. Those objections involved the Professional Services Exclusion that the magistrate's report did not address, but the court found inapplicable because of allegations of both professional and non-professional negligence. *See Gulf Coast*, 2015 WL 3648859, at *2–*3. In addition, the court agreed that exclusion j.(6) did not apply because the RTO was put to use before any damage occurred. *Id.* at *3–*4. Noting that the Magistrate Judge "ably discussed" the "contractual liability" exclusion, the court agreed that at least one covered claim was alleged and that the exclusion did not bar the duty to defend. *Id.* at *4. Regarding the "your product" and "your work" exclusions, the court agreed with the Magistrate Judge's analysis that the underlying pleadings were "far from clear" but raised the potential of damage to non-Gulf Coast property sufficient to trigger the duty to defend. *Id.* at *5. The court also rejected ASI's objection regarding the "sudden and accidental physical injury" exception to the "impaired property" exclusion, claiming that Gulf Coast did not demonstrate that the flooding was "temporally sudden." The pleadings potentially supported a claim that the flooding was sudden as opposed to something that occurred over time. *Id.* at *6–*7. Finally, the court agreed that the duty to defend was triggered by the allegations of the Original Complaint against Gulf Coast. *Id.* at *7.

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[7] ASI also asserted the "sistership" exclusion (exclusion n.) as an affirmative defense, but not as a ground for summary judgment. The court briefly addressed the exclusion noting that Piramal sought damages far in excess of those listed in that exclusion. *Gulf Coast*, slip op. at 31–32.

Commentary:

Then-Magistrate Judge Hanks' report and recommendation in *Gulf Coast* is a perfect illustration of the breadth of the duty to defend under Texas law. As noted throughout the opinion, the duty to defend standard requires a liberal interpretation of the pleadings favoring insurance coverage for the insured. While it may be that the actual facts reveal that no damage existed beyond the insured's own work or products such that those related exclusions may apply, the duty to defend is triggered even if the duty to indemnify may never exist.

VII. *Lend Lease (US) Construction, Inc. v. Amerisure Mutual Insurance Co., No. 4:13-CV-03552, --- WL --- (S.D. Tex. June 16, 2015)*

In June 2015, in an unpublished decision from the Southern District of Texas, Amerisure prevailed against an additional insured on the application of the "your product" and "your work" exclusions. *See Lend Lease (US) Construction, Inc. v. Amerisure Mutual Insurance Co.*, No. 4:13-CV-03552, --- WL --- (S.D. Tex. June 16, 2015).

A. Background Facts

Lend Lease (US) Construction, Inc. was hired as a general contractor to erect St. Mark's Medical Center ("SMMC"). For the flooring installation, Lend Lease subcontracted with Texan Floor to install two different types of flooring in the SMMC. As part of its agreement with Lend Lease, Texan Floor agreed to name Lend Lease as an additional insured on its CGL policies, which were issued by Amerisure Mutual Insurance Co.

During construction, because of high moisture content emitting from the concrete slab, Texan Floor determined that it needed to apply a moisture sealant before installing the flooring. While it recommended using "bead blasting," Lend Lease recommended that it use a less expensive "Taylor Lockdown System," and Texan Floor did so. In June 2005, after moving in to the building, SMCC noticed "bubbling," "loose flooring" and "weeping" at or around the tile flooring. Initially, the problems were noticed only in a couple rooms of the hospital, but by the time litigation ensued, three-fourths of the hospital flooring had to be replaced.

SMMC commenced a lawsuit against Lend Lease and Texan Floor for its damages. Lend Lease tendered the lawsuit to Amerisure for a defense and indemnity, but Amerisure denied coverage, claiming that the damage did not arise out of Texan Floor's work for Lend Lease. After a request to reconsider, Amerisure accepted the defense subject to a reservation of rights. A couple months later, however, Lend Lease filed suit against Amerisure and Texan Floor's excess carrier, Ohio Casualty. In February 2014, Lend Lease notified those insurers that it had negotiated a settlement with SMMC and requested that the insurers satisfy the settlement, but Amerisure refused to contribute and Ohio Casualty followed suit. With money from its own insurer apparently, Lend Lease settled the SMMC lawsuit. In the coverage litigation, in the meantime, the parties ultimately filed cross-motions for summary judgment regarding coverage.

B. Is there "Property Damage"?

After examining the Texas standards for determining an insurer's duty to defend versus its duty to indemnify, the court turned to the first dispute—whether "property damage" existed. The court noted that the definition of "property damage" was standard—i.e., "property damage" was defined as "physical injury to tangible property, including all resulting loss of use of that property." The court first noted the holding of *Lennar Corp. v. Great American Insurance Co.*, 200 S.W.3d 651 (Tex. App.—Houston [14th Dist.] 2006, no pet.), in which the dispute at issue centered on the installation of defective EIFS that caused water damage to some of the homes on which it was installed. *See Lend Lease*, slip op. at 14. In that case, the wood rot and damage to substrate was "property damage" because it was "physical injury to tangible property." *Lennar Corp.*, 200 S.W.3d at 677–78. The EIFS itself, however, in cases in which no resultant "property damage" existed, "was not physically injured after application, nor did it change from a satisfactory to an unsatisfactory state." *Id.* at 678–79. Rather, the installation was inherently defective and, therefore, it was not "property damage." *Id.*

Later, in 2007, the court noted that the Supreme Court of Texas addressed the "property damage" issue in *Lamar Homes, Inc. v. Mid-Continent Casualty Co.*, 242 S.W.3d 1 (Tex. 2007). *See Lend Lease*, slip op. at 14. In that case, the Court held that "property damage" by definition does not preclude the actual work of a contractor. "Rather, in *Lamar Homes*, the [C]ourt found that damaged sheetrock, installed by the contractor, which became cracked due to the contractor's defective workmanship on the foundation, constituted property damage under the insurance policy." *Id.* (citing *Lamar Homes*, 242 S.W.3d at 9–10).

With those decisions as a guide, the court turned to the facts before it and the distinction between those two cases with respect to defective work. The court noted that Lend Lease did not contend that the flooring caused damage to the existing SMMC structure. Instead, Lend Lease claimed that the damage was the defectively installed floor itself. Ultimately, the floor was damaged because of the Taylor system's failure to properly account for slab moisture, resulting in the need to replace the floor. But unlike in *Lennar*, the floor actually was damaged by "bubbling," separation at the seams, detachment and "weeping." And, under *Lamar Homes*, damage to the insured's own work is not precluded from coverage by the definition of "property damage." Thus, the court found that "property damage" existed and Lend Lease met its burden on that issue.

C. The Exclusions – "Your Product" and "Your Work"

The "your product" exclusion bars coverage for "'Property damage' to 'your product' arising out of it or any part of it." *Id.* at slip op. 15. Additionally, the "your work" exclusion bars coverage for "'Property damage' to 'your work' arising out of it or any part of it and included in the 'products-completed operations hazard.'" *Id.* at 16. Importantly, though, that exclusion is subject to an exception that reinstates coverage "if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor." *Id.*

Regarding the first exclusion, whether it applied was dependent on whether Texan Floor "sold, handled, distributed or disposed of the product" where "handled" means "'to deal or trade in' rather than 'to touch.'" *Id.* at 17 (quoting *Todd Shipyards Corp. v. Turbine Serv., Inc.*, 674

F.2d 401, 420 (5th Cir. 1982)). "Cases considering the same language have found that 'your product' and 'your work' exclusions apply to both the product and its installation." *Id.* (citing *Bldg. Specialties, Inc. v. Liberty Mut. Fire Ins. Co.*, 712 F. Supp. 2d 628, 646–47 (S.D. Tex. 2010)). The court rejected Lend Lease's claim that the "your product" exclusion was inapplicable because the floor was installed as a component of a larger structure, noting that other courts had applied the exclusion in such situations. *Id.* Thus, "[t]he installation of and the flooring itself constituted Texan Floor's 'work' and 'product' under the Amerisure policies." *Id.*

Despite the fact that the "your product" exclusion negated coverage, the court also addressed Lend Lease's argument that it benefited from the subcontractor exception to the "your work" exclusion because the work was performed by its subcontractor, Texan Floor. The definition of "your" however, refers specifically to the Named Insured on the policy, Texan Floor, not the additional insured. Therefore, the court held that the exception to the "*your* work" exclusion applies only when Texan Floor's work is performed by subcontractors *it* retained.[8]

Further, the court agreed that the exclusions only preclude coverage for the cost to repair or replace the insured's defective work and not damage to other property resulting from it. But, as noted by the court, Lend Lease did not argue that there was any resultant damage to other property that could be covered. The "loss of use, infection control and containment damages" at issue were simply costs associated with the repair or replacement of the floor. *Id.* at 18. Accordingly, the court found that Amerisure met its burden to establish that the exclusions negated coverage for all the damages at issue.

Commentary:

The *Lend Lease* decision is a refresher course on some of the key issues that arise in routine construction defect cases. The term "property damage" means physical injury to tangible property and it does not matter if the damage is to an insured's own work for purposes of satisfying the "property damage" definition. Further, in addressing coverage for a general contractor as an additional insured on a subcontractor's policy, the focus remains on that subcontractor's products and work—not whether it is the additional insured's products or work. Simply put, this is not a surprising result—just a reminder of what arguments will not prevail in a construction defect insurance coverage dispute.

VIII. *Stone Creek Custom Homes, LP v. Mid-Continent Casualty Co.*, No. SA-14-CA-1115, — WL — (W.D. Tex. July 7, 2015)

In another unpublished decision, the Western District of Texas amplified the importance of pleadings in a duty to defend case. *See Stone Creek Custom Homes, LP v. Mid-Continent Casualty Co.*, No. SA-14-CA-1115, — WL — (W.D. Tex. July 7, 2015). Latching onto a single allegation against the insured that all its work was defective, the court found that exclusion j.(5) applied to negate the duty to defend.

[8] Although not set forth in the opinion, Lend Lease also argued that the "your work" exclusion should not apply to it because "your" applies only to the named insured's work and Lend Lease sought coverage as an additional insured. Even so, the fact remains that the damaged work in question (i.e., the flooring) was in fact the named insured's work. Accordingly, the exclusion applied and it did not matter that it was the additional insured that sought coverage.

A. Background Facts

Stone Creek Custom Homes contracted with a couple to build them a home within a six-month period. Nine months into the project, the homeowners alleged that Stone Creek only had completed a third of the work. Ultimately, Stone Creek filed suit against the homeowners, contending that they had wrongfully terminated them from the job and had breached the parties' contract. In response, the homeowners filed a counterclaim, alleging defective and incomplete work that caused damage to those portions of the home that had been built. Most importantly, the homeowners alleged that, of the work that had been performed, all of it was "defective, deficient, and/or inferior to industry standards." Slip op. at 3. Stone Creek tendered the claims to its insurer, Mid-Continent Casualty Co., for a defense and indemnity, but Mid-Continent denied coverage. Eventually, the underlying lawsuit settled, but not before Stone Creek filed suit against Mid-Continent for breach of the duty to defend. On cross-motions for summary judgment, the court addressed the coverage issues between the parties.

B. Was there an "Occurrence"?

After first finding that clear allegations of "property damage" existed,[9] the court turned to whether there was an "occurrence" sufficient to satisfy the insuring agreement of Stone Creek's insurance policy. Relying on the Supreme Court of Texas's discussion of an "occurrence" in cases of faulty workmanship, the court discussed Mid-Continent's argument that the failure to dry-in the roof and waterproof the house was not caused by an "occurrence" because the damage resulting therefrom was the "natural and expected result of the insured's actions." *Id.* at 9 (citing *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 242 S.W.3d 1, 9 (Tex. 2007)). Agreeing, the court found that the damages were the expected result of an insured's failure to construct adequate roofing and the failure to dry-in the roof system. *Id.* at 9–10. However, with respect to all the other allegations of defective workmanship, the court found that an "occurrence" existed.

C. Exclusion J.(5)

Having agreed with Stone Creek that at least some of the allegations were sufficient to allege that an "occurrence" existed, the court turned to Mid-Continent's claim that exclusion j.(5) negated coverage for any damages resulting from such an "occurrence." The court agreed with Mid-Continent that all the defective work necessarily occurred during the course of "ongoing operations," triggering the exclusion. *Id.* at 11. Moreover, the court agreed that the homeowners alleged that the property damage at issue was caused by such defective work and it necessarily occurred during those ongoing operations. Simply put, there were no allegations that the work had been suspended or was inactive when the property damage occurred.

Further, the court looked to the phrase "that particular part," noting that the Fifth Circuit Court of Appeals previously had held that that phrase limited the scope of the exclusion and that "the exclusion does not bar coverage for damage to parts of a property that were the subject of only nondefective work by the insured and were damaged as a result of defective work by the insured on other parts of the property." *Id.* at 12 (quoting *Mid-Continent Cas. Co. v. JHP Dev.,*

[9] Allegations clearly existed of damage to the foundation, framing, plumbing lines, roof, and water damage to the interior of the home.

Inc., 557 F.3d 207, 213 (5th Cir. 2009)). Mid-Continent argued, and the court agreed, that the homeowners alleged that all the work at issue was defective. Thus, "there were no parts of the property that were the subject of only nondefective work." *Id.* Despite allegations of damage to "in place" plumbing lines, the court held that the exclusion applied because the court would have to "imagine factual scenarios which might trigger coverage"—i.e., that the plumbing lines were installed by an earlier contractor—which the court could not do under Texas's "eight corners" rule. *Id.* at 12–13 (citing *Gore Design Completions, Ltd. v. Hartford Fire Ins. Co.*, 538 F.3d 365, 369 (5th Cir. 2008)). Thus, Mid-Continent had no duty to defend.

Commentary:

Stone Creek is the poster child for what not to do as a plaintiff's lawyer expecting to trigger a defendant's CGL insurance coverage. Because CGL policies respond to claims of damages because of "property damage" and not defective work, claims that all the work at issue was defective will bar coverage for the defendant when the damage at issue occurred during the course of construction. In post-completion damage cases, the risk of negating the duty to defend is much lower, so long as the insured hired subcontractors to perform the work and the "subcontractor exception" to the "your work" exclusion has not been deleted by endorsement. At least to date, Texas courts have not made a distinction between damage to defective work as opposed to damage to non-defective work with respect to that exclusion. Regardless, because the duty to defend is governed by the underlying claimant's allegations, it is important to plead carefully. Here, it likely was not at all true that *all* the work was performed defectively. But, in the context of the "eight corners" rule, the court is bound by what is alleged—not by the actual facts.

IX. *Feaster v. Mid-Continent Casualty Co.*, No. 15-20074, 2015 WL 5050136 (5th Cr. Aug. 27, 2015)

The first construction-related CGL decision of 2015, *Feaster v. Mid-Continent Casualty Co.*, No. 4-13-CV-3220, 2015 WL 164041 (S.D. Tex. Jan. 13, 2015), was later affirmed by the U.S. Fifth Circuit Court of Appeals in August. *See Feaster v. Mid-Continent Cas. Co.*, No. 15-20074, 2015 WL 5050136 (5th Cir. Aug. 27, 2015).

A. Background

In *Feaster*, the Feasters had purchased a home from Kingwood Estate Homes, L.L.C., which was insured by Mid-Continent. Kingwood's policies were consecutively issued between April 2004 and April 2009. Several years after purchasing the home in 2005, the Feasters encountered structural and cosmetic damages to the home. By way of example, in the spring of 2008, the Feasters noticed cracking in the tile flooring in their kitchen and, after they were replaced, they cracked again in the summer of 2009. Over the ensuing years, the cracks worsened and other damages developed. Ultimately, the Feasters sued Kingwood and other defendants. When Kingwood tendered the lawsuit to Mid-Continent, the insured disclaimed coverage, relying on exclusions j. and l. Notably, in every policy, exclusion l. was modified by endorsement to eliminate the so-called "subcontractor exception" from the exclusion. After the denial, Kingwood did not answer the Feasters lawsuit and a default judgment was entered against

the company. When the Feasters were unable to collect on the judgment, they obtained a turnover order from Kingwood and filed suit against Mid-Continent. *Id.* at *1.

B. The "Your Work" Exclusion

The Feasters acknowledged that the damage at issue occurred after completion of the home, so only exclusion l. potentially applied to negate coverage. Nevertheless, they argued that the exclusion was unconscionable and, therefore, unenforceable because it reduces the policies to "phantom polic[ies], not covering anything." *Feaster*, 2015 WL 164041 at *2. The district court and court of appeals, however, ultimately disagreed.

As modified, the exclusion at issue precluded coverage for "property damage" to Kingwood's work "arising out of it or any part of it and included in the 'products-completed operations hazard.'" On appeal, the Feasters argued that the exclusion was not applicable because there was no damage to the insured's work; rather, the Feasters claimed that the soil heaved as a result of the insured's inadequate preparation of the lot, which eventually caused problems with the foundation and, subsequently, cosmetic and structural damage. *See Feaster*, 2015 WL 5050136 at *2. Arguing that the house itself was the insured's work, the Feasters claimed that the soil was not a part of that work. Discussing the court's prior decision in *Wilshire Insurance Co. v. RJT Construction, LLC*, 581 F.3d 222 (5th Cir. 2009), the court acknowledged that, in that case, it found the exclusion did not preclude coverage because the insured was retained to merely repair the foundation, which caused damage to the house that it had not built. On the other hand, in *Feaster*, Kingswood was contracted to build the entire house, which included construction of the foundation and preparation of the soil. *See Feaster*, 2015 WL 5050136 at *3. Because the Feasters did not dispute that the "products-completed operations hazard" requirement of the exclusion was satisfied, and all the damage was to the insured's work, the court affirmed the district court's opinion that no coverage existed. The court also concluded that the Feasters had abandoned the argument that the "your work" exclusion as endorsed to remove the "subcontractor exception" was unconscionable.

Commentary:

The decision in *Feaster* is straight-forward. When the "your work" exclusion is modified by endorsement to eliminate the "subcontractor exception," the scope of the exclusion becomes significantly broader. As such, from the perspective of a policyholder (or any potential future claimant, for that matter), removal of any such endorsements is critical to preserving the potential for coverage when the damages at issue are to the subject matter of the insured's contract. And, although the Feasters abandoned the unconscionable argument on appeal, it is safe to assume the Fifth Circuit would have rejected that argument as the endorsement that removes the subcontractor exception (CG 22 94) is an ISO endorsement that has been consistently applied by other courts—including the Fifth Circuit.