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

THE POLICYHOLDERS' PERSPECTIVE

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In *Great American Insurance Co. v. Hamel*, 525 S.W.3d 655 (Tex. 2017), the Supreme Court of Texas addressed what constitutes a "fully adversarial trial" under the *Gandy* rule. *Id*. (citing *State Farm Fire & Casualty Co. v. Gandy*, 925 S.W.2d 696, 714 (Tex. 1996)). The Court held that a reviewing court must focus on the insured's incentives to contest liability at the time of trial, as opposed to an evaluation of trial strategies and tactics.

A. Background Facts

The Hamels sued their builder, Terry Mitchell Builder's Inc. (the "Builder"), for water damage allegedly caused by an improperly installed Exterior Insulation and Finish System ("EIFS"). Great American provided liability insurance to the Builder for five years. The fourth and fifth years contained an Exterior Stucco exclusion. Based on the fact that damage was discovered during the fifth year, Great American denied a defense for the Hamels' claim.

Before trial, the Hamels essentially agreed not to enforce any judgment against Terry Mitchell individually or against any "personal tools of the trade and [his] truck"—which were essentially all of the company's assets. Before a bench trial, the Builder stipulated to certain facts that supported Hamels' claims and Mr. Mitchell testified consistent with those stipulations at trial. The Hamels offered evidence to support their claims, but the Builder did not call any witnesses or raise any objections to the Hamels' evidence. In lieu of closing argument, the Court accepted the Hamels' attorney's suggestion that the parties submit findings of fact and conclusions of law. However, only the Hamels submitted proposed findings. The trial court adopted the Hamels' uncontested findings and awarded the Hamels damages for repair costs, loss of market value, and mental anguish. Builder then assigned most of its rights against Great American to the Hamels.

Subsequently, the Hamels sued Great American to recover the amounts they were awarded against the Builder. The Hamels went to a bench trial on a breach-of-contract claim. The underlying record and the stipulations were admitted at trial and the court entered judgment for the Hamels. On appeal, Great American argued that *Gandy* precluded enforcement of the underlying judgment against the Builder because the judgment was rendered without a "fully adversarial trial." *Id*. at 662 (citing *Gandy*, 925 S.W.2d at 714). The El Paso Court of Appeals affirmed, holding the underlying judgment was the result of a fully adversarial trial and that the Builder's assignment of its claims against Great American to the Hamels was valid. *Id*. (citing *Great Am. Ins. Co. v. Hamel*, 444 S.W.3d 780 (Tex. App.—El Paso 2014, pet. granted)).

B. *Gandy's* "Fully Adversarial Trial" Requirement

Initially, the Supreme Court reiterated *Gandy*'s two-pronged conclusion that:

> [A] defendant's assignment of his claims against his insurer to a plaintiff is invalid if (1) it is made prior to an adjudication of plaintiff's claim against defendant in a fully adversarial trial, (2) defendant's insurer has tendered a defense, and (3) either (a) defendant's insurer has accepted coverage, or (b) defendant's insurer has made a good faith effort to adjudicate coverage issues prior to the adjudication of plaintiff's claim.

Gandy, 925 S.W.2d at 714. The *Gandy* Court independently concluded: "In no event . . . is a judgment for plaintiff against defendant, rendered without a fully adversarial trial, binding on defendant's insurer or admissible as evidence of damages in an action against defendant's insurer by plaintiff as defendant's assignee." *Id*.

Great American conceded the validity of the Builder's assignment to the Hamels under *Gandy*. Further, the Court confirmed that the assignment was valid because: a) the Builder assigned its claims after, not before, a trial and judgment; b) unlike the insurer in *Gandy*, Great American breached its duty to defend; and c) Great American neither accepted coverage nor made a good-faith effort to adjudicate coverage before the Hamels' claims against the Builder were resolved. *Hamel*, 525 S.W.3d at 664.

Nevertheless, Great American argued that, independent of the assignment's validity and despite its failure to defend, *Gandy* precluded enforcement of the judgment against Great American solely because it was "rendered without a fully adversarial trial." *Id*.

Referring to *Employers Casualty Co. v. Block*, 744 S.W.2d 940, 943 (Tex. 1988), the Supreme Court had previously indicated that, in light of its failure to defend, an insurer "was barred from collaterally attacking the agreed judgment by litigating the reasonableness of the damages recited therein." *Id.* Further, in *Evanston Insurance Co. v. ATOFINA Petrochemicals, Inc*., 256 S.W.3d 660, 671 (Tex. 2008), the Court applied *Block* when an insurer breached its duty to defend, avoiding *Gandy's* "fully adversarial trial" rule because "*Gandy*'s key factual predicate [was] missing" in that the insured had not assigned its claims but had sued the insurer directly. *Id*. The *Hamel* Court noted that *Gandy*'s "fully adversarial trial" requirement had shifted focus away from an insurer's failure to defend and "toward whether the underlying judgment accurately reflects the plaintiff's damages and thus the insured's covered loss." *Id*.

C. What Constitutes a "Fully Adversarial Trial"?

The Court rejected the Court of Appeals' approach to "retroactively evaluate and thus second-guess trial strategies and tactics" because it "often produces an inaccurate and unreliable result." *Id*. at 666. Accordingly, the Court announced a new rule:

> Today we clarify that the controlling factor is whether, at the time of the underlying trial or settlement, the insured bore an actual risk of liability for the damages awarded or agreed upon, or had some other meaningful incentive to ensure that the judgment or settlement accurately reflects the plaintiff's damages and thus the defendant–insured's covered liability loss.

Id. Based on that standard, the Court held that the underlying trial was not fully adversarial because "the parties' pretrial agreement eliminated any meaningful incentive the Builder had to contest the judgment" because the Builder "no longer has a financial stake in the outcome and thus likely has no interest in either avoiding liability altogether or minimizing the amount of damages." *Id*. at 667. The lack of an incentive rendered the underlying suit "a mere formality—a pass-through trial aimed not at obtaining a judgment reflective of the Hamels' loss, but instead at obtaining a potentially inflated judgment to enforce against Great American." *Id*.

The Hamels argued that, in the event that the Court found there was a lack of adversity during the underlying liability trial, the problem was cured during the Insurance Trial. The Court noted that, although "we will not hold an insurer to a judgment that was not the result of an adversarial proceeding, we will not preclude the parties from properly litigating the underlying liability issues in a subsequent coverage suit." *Id*. at 669. The Court recognized that "relitigation of underlying liability and damages issues is not a perfect solution, but it is necessitated by the circumstances." *Id*. Specifically, the Court stated:

> [U]nder the approach we adopt today, the insurer will have the opportunity to challenge its insured's underlying liability and the resulting damages, the abandoned insured is protected, and the burden on the plaintiff is fair. And of course, the insurer has every incentive to assert a strong defense during the Insurance Trial.

Id. The Court ultimately found that, although certain aspects of the Hamels' damages were discussed during the Insurance Trial, the scope of the Insurance Trial was not sufficiently broad to cure the problem with the lack of adversity. Accordingly, the Court remanded the case to the trial court "in the interest of justice." *Id*. at 670.

D. Commentary

In *Hamel*, the Supreme Court of Texas reiterated the "fully adversarial trial" requirement in *Gandy*. However, it shifted the focus from second-guessing trial tactics and strategies to whether the insured had a financial incentive. This raises the question of whether an insured that is otherwise judgment proof can ever have a financial incentive to challenge a plaintiff once its insurance carrier has denied it a defense. Although an insurance carrier cannot avoid liability altogether when it improperly denies a defense and the underlying case is not the result of a fully adversarial trial, the insurer can challenge the issues not addressed in the underlying case during a subsequent coverage action, as was required in *Hamel*. As *Hamel* represents a shift in focus, its full contours will be developed through other cases in the years to come.

II. *Mt. Hawley Insurance Co. v. Slay Engineering*, 335 F. Supp. 3d 874 (W.D. Tex. 2018).

In *Mt. Hawley Insurance Co. v. Slay Engineering*, 335 F. Supp. 3d 874 (W.D. Tex. 2018), the United States District Court for the Western District of Texas found various exclusions did not apply to allegations against a general contractor for breach of contract and negligence. Most notably, the court rejected the application of a "breach of contract" exclusion with respect to the insurer's duty to defend.

A. Background Facts

Slay Engineering/Texas Multi-Chem/Huser Construction ("Huser") had a commercial general liability policy from Mt. Hawley Insurance Company. Huser contracted with the City of Jourdanton to design and construct a municipal sports complex. The project consisted of four little league baseball fields, a softball field, parking lots and a new swimming pool. Huser subcontracted with Cody Pools, Inc. to design and build the swimming pool. Huser also subcontracted with Q-Haul, Inc. for earth work, grading and storm drainage work at the site.

After substantial completion of the project, a Huser employee noticed cracks in the pool and parking lot paving. Cody Pool began repair work, but the problem was not cured. The City later notified Huser of several alleged deficiencies involving the swimming pool structure, asphalt paving, concrete flatwork and curbing, and overall drainage. When the City was not happy with the repair proposal, it sued Huser for breach of contract and negligence.

Huser provided notice to Mt. Hawley of the lawsuit against it, but Mt. Hawley denied coverage based on certain exclusions. Mt. Hawley then filed suit, seeking a judgment that it had no duty to defend or indemnify Huser. Mt. Hawley relied on the "damage to your work" exclusion, which precludes 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 881. The exclusion includes an exception, however, "if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor." *Id*. The policy included a separate endorsement that excluded coverage arising directly or indirectly out of a breach of "express or implied contract, breach of express or implied warranty or fraud or misrepresentation regarding the formation, terms or performance of a contract." *Id*.

B. "Breach of contract" Exclusion Only Applies When the Breach is a "But For" Cause of Property Damage

The parties both moved for summary judgment, and Mt. Hawley argued the "breach of contract" exclusion applied because "but for the Contract, there would be no cause of action to bring against Huser." *Id*. at 884. The court rejected that argument, finding that Mt. Hawley conflated Huser's causation of "property damage" with Huser's ultimate liability for economic losses. Specifically, the court found:

> Merely because Huser may ultimately be liable for certain of the City's economic losses under a breach of contract theory does not mean that all of the alleged property damage was causally attributable to Huser's alleged breach of its contract with the City.

Id. at 885. The Court found that the "directly or indirectly" and "arising out of" language in the exclusion required Mt. Hawley to demonstrate that Huser's breach of the contract was a "but for" cause of the alleged property damage. "The fact that all claims contained in the underlying suit have some relation to Huser's contract with the City or that Huser has been sued for breach of contract are not enough to trigger the Breach of Contract exclusion." *Id*. Although the underlying petition alleged certain acts that indicated the breach of contract caused the "property damage," for Mt. Hawley to prevail, the facts alleged in the underlying suit would have to demonstrate that there were *no other* independent, covered (non-excluded) "but for" causes of the alleged property damage. *Id*.

The Court then noted that the underlying suit alleged that "work performed by [Huser], its subcontractors and suppliers, was defective." *Id*. at 886. Therefore, the underlying suit alleged that entities other than Huser were responsible for the allegedly defective work and the resulting damage. Accordingly, the allegations left open the possibility that the property damage may have occurred "even in the absence of" a breach of contract or implied duty by Huser. *Id*. at 886 (citing *Utica Nat'l Ins. Co. of Tex. v. Am. Indem. Co*., 141 S.W.3d 198, 203 (Tex. 2004) (concluding that

the insurer had duty to defend when injury or damage "could" have occurred even absent the excluded conduct)).

C. "Breach of Contract" Exclusion does not Override the Subcontractor Exception to the "Damage to Your Work" Exclusion

Mt. Hawley argued the subcontractor exception to the "damage to your work" exclusion was irrelevant because it was overridden by the endorsement containing the "breach of contract" exclusion. *Id*. But the court noted that a natural reading of the "breach of contract" exclusion was that "it pertains to [the insured's] liability for repairing its own deficient work or to specific contractual obligations that [the insured] has assumed." *Id*. at 887 (citing *Mt. Hawley Ins. Co. v. Aguilar*, No. SACV 07-00969, 2008 WL 11342656, at *3 (C.D. Cal. Feb. 29, 2008)). It is "not natural to read it to encompass all work incidentally related to the project regardless of the party that performed the work or the capacity in which it did so." *Id*. The court rejected the sweeping interpretation asserted by Mt. Hawley and instead found that the policy should be interpreted such that the subcontractor exception to the "damage to your work" exclusion still had meaning. *Id*. Therefore, Mt. Hawley had a duty to defend. Having found a duty to defend, Mt. Hawley's motion on the duty to indemnify was also denied because it was premature to determine whether it had such a duty. *Id* at 888–89.

D. Commentary

The interesting aspect of *Slay Engineering* is the court's finding that the breach of contract exclusion does not override the subcontractor exception in the "damage to your work" exclusion. Often courts will find that endorsements trump the base policy language. Moreover, each exclusion is supposed to be read individually even if the result is that the application of one or more exclusions results in an overlap. Nonetheless, *Slay Engineering*, does provide support for insureds that are seeking a duty to defend on claims arising from an alleged breach of a construction contract where the work was performed by a subcontractor. The *Slay Engineering* case presents a split in the district courts as a different court applied the breach of contract exclusion to negate any and all coverage for claims against a general contractor. *See Scottsdale Ins. Co. v. Mt. Hawley Ins. Co.*, Civ. A. No. M-10-58, 2011 WL 9169946 (S.D. Tex June 15, 2011), *aff'd*, 488 F. App'x 859 (5th Cir. 2012) (not designated for publication). In light of the split in the district courts on this issue, it is likely this matter will be appealed to the Fifth Circuit Court of Appeals.

III. *Satterfield & Pontikes Construction, Inc. v. United States Fire Insurance Co.*, 898 F.3d 574 (5th Cir. 2018)

In *Satterfield & Pontikes Construction, Inc. v United States Fire Insurance Co*., 898 F.3d 574 (5th Cir. 2018), the United States Court of Appeals for the Fifth Circuit examined an excess insurance provider's refusal to cover damages incurred by an insured general contractor after it was terminated from a construction project.

A. Background Facts

Satterfield & Pontikes Construction, Inc. ("S&P") was hired as general contractor for a courthouse project in Zapata County, Texas. S&P purchased two layers of insurance to cover potential liabilities: a commercial general liability insurance policy and an excess insurance policy. The

excess insurance policy issued by United States Fire Insurance Company ("U.S. Fire") only applied when the first layer was exhausted. Further, the court noted that the U.S. Fire policy was not all-inclusive – it barred coverage for fungi, mold or bacteria and also did not cover attorney's fees or other legal costs.[1] S&P also required its subcontractors to purchase insurance and execute indemnity agreements to cover damages they caused to the project.

Following problems with construction of the project, Zapata County terminated S&P and filed suit to recover the costs it incurred to complete and correct S&P's work. An arbitration panel awarded Zapata County over $8 million in damages, fees, and costs. S&P included its subcontractors in the arbitration and was able to recover approximately $4.5 million of the award through settlement agreements with its subcontractors and two third parties. The settlement agreements released S&P's claims against those parties but did not specifically allocate the proceeds to the damages or liabilities they covered. S&P also obtained just over $3 million from its primary commercial general liability insurance carriers.

S&P sought to obtain coverage for the balance of the award from U.S. Fire. U.S. Fire refused to pay any amount, arguing its policy was not implicated because the first layer of insurance had not been completely exhausted. U.S Fire further argued that not all of the damages awarded in the arbitration were covered under its policy (*e.g.*, mold, attorneys' fees, and prejudgment interest), and the costs that might have been covered were subject to the subcontractor settlements. As a result, U.S. Fire claimed that there was no shortfall in the arbitration award for it to pay.

The district court granted summary judgment to U.S. Fire, holding that "S&P cannot unilaterally allocate all of its settlement proceeds to uncovered losses in order to manufacture a covered loss." *Id*. at 578. Relying on *RSR Corp. v. International Insurance Co.*, 612 F.3d 851 (5th Cir. 2010), a case not cited by the parties, the district court placed the burden on S&P to demonstrate that the settlement proceeds could be properly allocated to the non-covered portions of the excess policy and held that S&P failed to satisfy that burden. *Id.*

B. Settlement Payments from Subcontractors was "Other Insurance" under the Terms of the Excess Policy

The Fifth Circuit first examined whether the settlement payments from the subcontractors qualified as "Other Insurance" under the excess policy such that U.S. Fire could consider the payments in determining whether its policy was implicated. The court explained that the U.S. Fire policy defined "Underlying Insurance" as S&P's commercial general liability insurance and defined "Other Insurance" as "any type of Self-Insurance or other mechanism by which an Insured arranges for funding of legal liability for which this policy also provides coverage." *Id*. at 579. The court found that the plain language of the "Other Insurance" definition supported affirming the trial court's summary judgment order. In particular, the court found that the indemnity agreement in the subcontractor contracts:

> [F]alls under the plain language of the "Other Insurance" provision of U.S. Fire's policy—which is very broad—because it is a "mechanism by which

[1] In a footnote, the court cites to *In re Nalle Plastics Family Ltd. P'ship*, 406 S.W.3d 168, 172-73 (Tex. 2013) for the proposition that in Texas attorney's fees and court costs awarded pursuant Chapter 38.001 of the Civil Practice and Remedies Cod are not damages and thus are not covered.

> an Insured arranges for funding of legal liabilities for which [U.S. Fire's] policy also provides coverage." And, under the reasoning of *RSR*, settlement proceeds resulting from an indemnity agreement also count as "Other Insurance."

Id. at 580 (citing *RSR Corp.*., 612 F.3d 851 (finding that settlement agreements with thirty-six comprehensive general liability insurers was "other insurance" to environmental policies and that the settlement amounts should be applied to offset covered losses)).

C. The Insured Bore the Burden of Allocating the Settlement Payments between Covered and Non-Covered Losses

The court then turned to the district court's decision regarding placing the burden on the insured to allocate the settlement proceeds between covered and non-covered losses. The district court explained that, under Texas law, the insured generally bears the burden of identifying the portion of a loss that was produced by a covered condition. *Id*. at 581 (citing *Comsys Info. Tech. Servs., Inc. v. Twin City Fire Ins. Co*., 130 S.W.3d 181, 198 (Tex. App.—Houston [14th Dist.] 2003, pet. denied)).

The Fifth Circuit looked to the Supreme Court of Texas's opinion in *Mobil Oil Corp. v. Ellender*, 968 S.W.2d 917 (Tex. 1998), to determine where Texas courts would place the burden. In *Ellender*, an independent contractor died from benzene exposure. The contractor's family sued multiple parties and reached settlement agreements with all but Mobil. When the jury returned a verdict in favor of the family, the Supreme Court of Texas was asked to address how the settlements impacted the jury verdict. The *S&P* court described the Supreme Court's analysis as follows:

> The linchpin of that court's reasoning was its concern that a litigant who is not party to the settlement had "almost no ability to prove which part of the settlement amount represented actual damages. Nonsettling parties should not be penalized for events over which they have no control." The Texas Supreme Court ultimately concluded that "[t]he better rule is to require a settling party to tender to the trial court, before judgment, a settlement agreement allocating between actual and punitive damages as a condition precedent to limiting dollar-for-dollar settlement credits to settlement amounts representing actual damages." Thus, where a settling party failed to allocate its settlement, the nonsettling party was entitled to a credit equaling the entire settlement amount.

Id. at 582 (citing *Ellender*, 968 S.W.2d at 928) (internal citations omitted).

The Court therefore held that S&P had the burden to show that the subcontractor settlement proceeds were properly allocated to either covered or non-covered damages. *Id*. at 583. Because S&P failed to timely raise a fact issue regarding the allocation of the settlement proceeds, the Fifth Circuit affirmed summary judgment in favor of U.S. Fire.

D. Commentary

In *Satterfield & Pontikes*, the court found that settlement payments from subcontractors should be allocated between covered and non-covered losses for purposes of determining the amount owed by an insurance carrier. Moreover, the court placed the burden on the insured to allocate the settlement and noted that the settlements did not contain an allocation. However, that begs the question of if the settlement agreement did contain such an allocation, would that allocation have been upheld. This certainly created an incentive to include an allocation in any settlement agreement that attributes the vast majority of the settlement proceeds to what would otherwise be covered losses.

IV. *Balfour Beatty Construction LLC v. Liberty Mutual Insurance Co.*, No. 17- 02477, 2018 WL 6831113 (S.D. Tex. Dec. 28, 2018)

In *Balfour Beatty Construction LLC v. Liberty Mutual Insurance Co*., No. 17- 02477, 2018 WL 6831113 (S.D. Tex. Dec. 28, 2018), the United States District Court for the Southern District of Texas examined a "defects, errors and omissions" exclusion, which barred coverage for a claim regarding damage to windows during a construction project, and whether an exception for resulting damage applied to reinstate coverage.

A. Background Facts

Balfour Beatty Construction LLC was the general contractor for the Energy Center 5 construction project. Milestone Metals Inc. was a subcontractor hired to perform certain welding work. While performing welding work near the 18th floor of Energy Center 5, welding slag from its work fell down the side of the building and damaged the glass on windows below requiring replacement. Milestone had not installed the windows.

The project developer obtained builder's risk insurance coverage for the project from Liberty Mutual. Once the damage was discovered, a claim was submitted to Liberty Mutual, who denied coverage based on a "defects, errors, and omissions" exclusion, which precluded coverage for "loss or damage … caused by, or resulting from an act … relating to … construction, materials, or workmanship … or … installation[.] But if an act, defect, error, or omission as described above results in a covered peril, 'we' do cover the loss or damage caused by that covered peril." *Id*. at *2. Balfour and Milestone then sued Liberty Mutual, asserting claims for breach of contract and violations of Chapters 541 and 542 of the Texas Insurance Code.

B. Application of the "Defects, Errors and Omissions" Exclusion

The court first examined whether the "defects, errors and omissions" exclusion applied to the insureds' claim. The court noted that the claim was for damage caused by an act relating to construction and, therefore, fell within plain, unambiguous language of exclusion. The insureds argued that the exclusion only applies to claims based on defects or damage to the insureds' own work. *Id*. at *5. However, the court rejected that argument, noting that while "parties can and do limit the exclusion to defects in the insureds own work when that is their intent, [t]he parties here simply did not draft their contract that way." *Id*. Because the language of the exclusion was clear, the court "is duty bound to enforce it as written." *Id*. at *6.

Balfour and Milestone also argued that wind (a covered cause of loss) contributed to the loss. *Id*. However, the court referred to the following quote from the Supreme Court of Texas regarding concurrent causation:

> Texas courts and the Fifth Circuit applying Texas law have recognized a distinction between cases involving "separate and independent" causation and "concurrent" causation when both covered ... and excluded events cause a plaintiff's injuries. In cases involving separate and independent causation, the covered event and the excluded event each independently cause the plaintiff's injury, and the insurer must provide coverage despite the exclusion. In cases involving concurrent causation, the excluded and covered events combine to cause the plaintiff's injuries. Because the two causes cannot be separated, the exclusion is triggered.

Id. (citing *Utica Nat'l Ins. Co. of Tex. v. Am. Indem. Co.*, 141 S.W.3d 198, 204 (Tex. 2004) (internal citations omitted)). Because the wind alone could not have independently caused the slag damage to the windows, the court concluded that wind was not a "separate and independent" cause of the loss. *Id*. Accordingly, because the wind was at best a concurrent cause, the exclusion still applied. *Id*.

C. The "Ensuing Loss" Exception does not Apply

Balfour and Milestone argued that, even if the "defects, errors and omissions" exclusion barred coverage for their claim, the following exception effectively reinstated coverage: "But if an act, defect, error, or omission as described above results in a covered peril, 'we' do cover the loss or damage caused by that covered peril." *Id*. at *7.

The judge rejected the insureds' position, finding that allowing the exception to reinstate coverage would "swallow" the exclusion. *Id*. In particular, the court found:

> There is only one instance of loss or damage in this case: the damage to the windows. The language of the exception, however, suggests that there needs to be at least two loss events. Parsing the exclusion, we find: 'But if an act, defect, error, or omission as described above'—that is, an excluded peril—'*results* in a covered peril,' then the loss or damage caused by the covered peril is covered. The language, then, calls for (1) an excluded peril that (2) 'results in' a covered peril. Since a peril cannot be simultaneously excluded and covered, the clause must be referring to two separate perils, one excluded and one covered. The Court finds that the 'results in' language is not ambiguous and is capable of being given a definite meaning, although the Court acknowledges that there is a recent decision, albeit vacated pursuant to an agreed motion of the parties, reaching the contrary conclusion.

Id. (citing *Nay Co. v. Navigators Specialty Ins. Co*., No. 3:16-CV-02675-N, 2018 WL 4026346, at *4 (N.D. Tex. June 12, 2018) (finding a nearly identical exception ambiguous "[b]ecause the phrase 'results in' is susceptible to more than one interpretation")) (emphasis added by court).

The insureds further argued that Liberty Mutual's interpretation of the exception would render coverage under the policy illusory for many of the risks that are typically covered under a builder's risk policy. *Id*. at *8. The Court recognized that the insureds' contention had some support in *Nay* because in that case the ensuing loss exception was found to reinstate coverage for two reasons: 1) because "result in" was found to be ambiguous allowing the insured's interpretation as long as it was reasonable; and 2) because the policy's protections would be "largely illusory" under the insurer's interpretation. *Id*. (discussing *Nay*, 2018 WL 4026346, at *5).

Although the court understood the *Nay* court's reasoning, it found that the result could not be reconciled with the Fifth Circuit's opinions that an unambiguous policy be enforced as written. Further, because the policy still provided coverage for certain risks (*e.g.*, acts of nature or Acts of God), the policy was not illusory. *Id*. Accordingly, the court found that Liberty Mutual did not breach the contract in denying coverage and granted summary judgment for Liberty Mutual.

D. Commentary

The *Balfour Beatty* case provides a fairly straightforward analysis of a faulty workmanship exclusion and ensuing loss provision. Even so, it presents a cautionary tale as not all "faulty workmanship" exclusions are created equal. The one here was written on the AAIS policy form and eliminates virtually any damage to property caused by construction errors. There are much narrower exclusions available in the insurance market. Additionally, the courts application of the concurrent cause doctrine is noteworthy. The court reinforced the distinction between losses resulting from "separate and independent" causes and concurrent causes. When two causes are separate and independent, then the loss is covered if one of the causes is covered (despite the presences of an excluded loss). However, when two causes of a loss are concurrent and one is excluded, the loss falls within the exclusion.

V. *Greystone Family Builders, Inc. v. Gemini Insurance Co.*, No. 17-921, 2018 WL 1579477 (S.D. Tex. Apr. 2, 2018)

In *Greystone Family Builders, Inc. v. Gemini Insurance Co*., No. 17-921, 2018 WL 1579477 (S.D. Tex. Apr. 2, 2018), the United States District Court for the Southern District of Texas adopted a magistrate judge's recommendation that an insurer's motion for summary judgment be denied because an underlying counterclaim filed against the insured contractor alleged an occurrence for which coverage under the policy is provided.

A. Background Facts

Greystone Multi-Family Builders Inc. entered into a contract with TPG (Post Oak) Acquisition LLC to perform services as a general contractor for a construction project. After Greystone purportedly did not fully perform its obligations under the contract, TPG terminated the contract and hired Allied Realty Advisors to complete the job. Greystone then filed suit against TPG and Allied. TPG filed a counterclaim against the contractor, alleging that Greystone breached the construction contract. When Greystone submitted the counterclaim to Gemini, the insurer denied a duty to defend or indemnify because the policy did not respond to property damage that occurred while Greystone was performing operations or for damage caused by mold. *Id*. at *1. When Greystone resubmitted its request, Gemini denied coverage on the basis that Greystone never

completed its work and the damage occurred in the course of Greystone's operations. *Id*. Greystone then sued Gemini for its attorneys' fees and a declaration judgment stating that Gemini had a duty to defend. Gemini cross-moved for summary judgment.

The magistrate judge issued a memorandum and recommendation ("M&R"), finding that the underlying allegations constitutes an occurrence for which coverage should be provided. Gemini objected to the M&R, and Greystone filed a motion for clarification as to whether Gemini's motion was denied in full.

B. Was there an "Occurrence"?

Gemini argued there was no "occurrence" because Greystone's actions were not an accident. *Id*. at *2. The magistrate judge considered the Supreme Court of Texas's decision in *Lamar Homes, Inc. v. Mid–Continent Casualty Co*., 242 S.W.3d 1, 4–5, 7 (Tex. 2007), which contained virtually identical language, to find:

> '[A] claim does not involve an accident or occurrence when either direct allegations purport that the insured intended the injury ... or circumstances confirm that the resulting damage was the natural and expected result of the insured's actions, that is, was highly probable whether the insured was negligent or not.'

Id. The magistrate judge found no allegations in the underlying complaint that Greystone intended its work to cause the damage or that the damage was the natural and expected result of Greystone's actions. *Id*. Gemini's main argument that there was no "occurrence" was that the counterclaim alleged that "Greystone hid costs so that it could continue to collect its contractor's fees, paid subcontractors up front so that it could collect higher contractor's fees resulting in lower incentive for them to complete their work, and withheld information from TPG, all of which Gemini contends resulted in predictably poor workmanship." *Id*.

The District Court found that, although at first glance the allegations in the counterclaim could lead one to conclude that the alleged damages were the result of Greystone's mismanagement, a closer inspection of the entire counterclaim revealed that many of the alleged damages were not predictable (*e.g.*, the framing subcontractor allegedly failed to construct frames with the required amount of studs; Greystone installed power conduits under the building's garage and these were later lost or destroyed when concrete was poured over them; the masonry subcontractor installed the trash-chute walls without leaving access to install the trash chutes, which required retrofitting of the doors; Greystone builders "forgot to install" pipe; and the emergency exit door was installed backwards). *Id*. at *3. As a result, the District Court found that the magistrate judge had correctly determined that some of the allegations in the counterclaim fell within the definition of "occurrence."

C. "Loss of Use" and "Property Damage"

Gemini agreed that there was some property damage to the project, but it objected to the magistrate judge's conclusion that the counterclaim alleged "property damage" in the form of "loss of use." *Id*. In particular, Gemini argued that the counterclaim only alleged increased construction costs

due to delay in the completion of the project but did not allege any actual loss of rents. *Id*. at *4. The policy defined "property damage" as follows:

> a. Physical injury to tangible property, including all resulting loss of use of that property. All such loss of use shall be deemed to occur at the time of the physical injury that caused it; or
>
> b. Loss of use of tangible property that is not physically injured. All such loss of use shall be deemed to occur at the time of the 'occurrence' that caused it.

Id. Based on this definition, the District Court agreed with the magistrate judge that the counterclaim contained some allegation of actual physical damage. Further, the District also agreed that the end goal of the construction project was to use the property as an apartment complex and charge rent; therefore, the delay in construction caused a "loss of use" within the definition of "property damage."

D. The Policy's Exclusions did not Preclude a Duty to Defend

The District Court addressed whether any of four exclusions barred coverage for the allegations against Greystone.[2]

i. Exclusion j.(5)

Exclusion j.(5) bars coverage for "property damage" to "that particular part of real property on which you . . . are performing operations, if the 'property damage' arises out of those operations." The District Court noted that this exclusion only applies to "property damage that occurred during the performance of construction operations." *Id*. at *4 (citing *Mid–Continent Cas. Co. v. JHP Dev., Inc*., 557 F.3d 207, 213 (5th Cir. 2009)). The court noted that there were no clear allegations as to when the damage actually occurred. Further, some of the alleged damage (*e.g.*, plumbing elements being cracked because the floor of the structure began to sag, water leaks due to improperly installed roofing systems, and leaks due to plaster and masonry being installed improperly) could have occurred after Greystone and its subcontractors were no longer working on the project. *Id*.

Gemini also requested that it be allowed to conduct limited discovery to ascertain when the property damage took place. The District Court addressed Texas case law recognizing the possibility that a narrow exception to the eight-corners rule may exist, but only if: (1) it is impossible to determine whether coverage is potentially implicated; and (2) the extrinsic evidence goes solely to a fundamental issue of coverage that does not overlap with the merits of or engage the truth or falsity of any facts alleged in the underlying case. *Id*. at *6 (citing *Allstate Cty. Mut. Ins. Co. v. Wootton*, 494 S.W.3d 825, 835–36 (Tex. App.—Houston [14th Dist.] 2016, pet. denied); *Liberty Mut. Ins. Co. v. Graham*, 473 F.3d 596, 601 (5th Cir. 2006) (discussing *GuideOne Ins. Co. v Fielder Rd. Baptist Church*, 197 S.W.3d 305, 308 (Tex. 2006)); *Northfield Insurance Co. v. Loving Home Care, Inc*., 363 F.3d 523 (5th Cir. 2004)). Because the court found that allowing

[2] Because Gemini did not attempt to actually establish that exclusion m.—the "impaired property" exclusion—applied, that exclusion is not addressed herein.

discovery would overlap with the merits of the allegations in the underlying complaint, the narrow exception to the eight-corners rule did not apply.

Based on the above, the District Court agreed with the magistrate judge that exclusion j.(5) did not allow Gemini to avoid its duty to defend.

ii. Exclusion j.(6)

Exclusion j.(6) bars coverage for "property damage" to "that particular part of any property that must be restored, repaired or replaced because 'your work' was incorrectly performed on it." The exclusion does not apply to property damage included in the products-completed operations hazard (*i.e.*, when all of the work called for in the contract is complete). The District Court noted that the exclusion bars coverage only for property damage to parts of a property that were themselves the subject of defective work by the insured. The District Court agreed with the magistrate judge that exclusion j.(6) did not apply to the extent the counterclaim alleged damage to parts of the property that were the subject of only non-defective work by the insured and were damaged as a result of defective work on other parts of the property.

In the M&R, the magistrate judge found that the counterclaim alleged that some of Greystone's work that was non-defective was damaged by defective work. *Greystone Family Builders, Inc. v. Gemini Insurance Co.*, No. 17-921, 2018 WL 3080890 (S.D. Tex. Feb. 26, 2018). For example, the counterclaim alleged that, because of defective structural work, "the floor of the structure began to sag and critical plumbing elements were damaged." *Id*. at *11. The counterclaim also alleged that the roof was installed defectively, which caused water leaks on the property. *Id*. The allegations also established that not all of Greystone's work was completed because the contract was never completed. *Id*. Therefore, the products-completed operations hazard was not implicated. Accordingly, exclusion j.(6) did not operate to bar the insurer's duty to defend.

E. "Fungus or Spore" Exclusion.

The District Court agreed with the magistrate judge that the policy's fungus or spore exclusion precluded coverage for some of the allegations in the counterclaim. 2018 WL 1579477 at *7. However, the court noted that the exclusion did not preclude coverage for all of the allegations; therefore, it did not preclude Gemini's obligation to provide Greystone with a defense. *Id*.

F. Commentary

The decision in *Greystone* is not necessarily monumental, as it effectively reiterates now long-standing Texas law on the application of standard construction-defect related exclusions like exclusions j.(5) and j.(6). Moreover, it reinforces the fact that, unless an insurer can assert a complete defense to coverage, a complete defense is owed to the insured. Going forward, and in that same vein, should the matter not otherwise be settled, any ultimate ruling by the District Court may be important in addressing the extent to which an insured can recover defense costs in regard to defense of an underlying lawsuit that includes affirmative claims that are not otherwise covered by the insured's policy.

VI. *Travelers Lloyds Insurance Co. v. Cruz Contracting of Texas, LLC*, No. 16-759, 2017 WL 5202891 (W.D. Tex. Sept. 7, 2017)

Travelers Lloyds Insurance Co. v. Cruz Contracting of Texas, LLC, No. 16-759, 2017 WL 5202891 (W.D. Tex. Sept. 7, 2017) is one of the few cases interpreting the Supreme Court of Texas' opinion in *U.S. Metals, Inc. v. Liberty Mutual Group., Inc*., 490 S.W.3d 20, 29 (Tex. 2015) and finding the that costs to access defective work can constitute "property damage" under the CGL policy.

A. Background Facts

D&D Contractors, Inc. ("D&D") entered into a subcontract with Cruz Contracting, LLC ("Cruz") for Cruz to perform certain utility work in connection with a residential development project in Boerne, Texas. During the construction project, Cruz had commercial general liability coverage with Travelers.

According to D&D, because of defective work performed by Cruz, D&D filed suit against Cruz. Cruz's faulty work on the Project required D&D to tear out and replace much, if not all, of Cruz's work on the sewer and water systems. *Id*. at *2. According to D&D, "[i]n order to replace the sewer system, D&D crews were required to excavate through the existing completed (with the exception of asphalt) roadways [that it] had previously and carefully constructed and passed all required testing with the City of Boerne." *Id*. The problems with the sewer system also caused damage to many items installed by others on the Project. *Id*. Cruz's faulty installation of the water system also required D&D to tear out and re-complete various roadways, curbs, and parkways. *Id.*

When D&D obtained a jury award in excess of $1 million, D&D and Cruz sought to have Travelers satisfy the judgment. Travelers filed a declaratory judgment action against D&D and Cruz, seeking a declaration that the judgment awarded against Cruz was not covered. Travelers filed summary judgment on the grounds that: (1) Travelers' policies do not cover the damages associated with the restoration, repair, or replacement of any of Cruz's defective work; (2) damage to property intentionally caused to access Cruz's defective work is not an "occurrence"; and (3) Travelers' policies do not cover attorneys' fees awarded under Chapter 38 of the Texas Civil Practice and Remedies Code. *Id*.

In response to Travelers' Motion, D&D and Cruz argued that they were not seeking coverage to repair Cruz's defective work, but rather were seeking coverage for the cost to access that defective work in order to repair damage to other parties' work on the project. *Id*. D&D and Cruz argued that such property damage independently qualified for coverage under the CGL policies. *Id*.

B. Was there "Property Damage"?

D&D and Cruz argued that the cost to replace roadways, curbs, and sidewalks that D&D had built above Cruz's defective work and the adjoining utility work done by other subcontractors was tangible property that, although not physically disturbed by Cruz's defective work, was rendered useless and constituted property damage under the CGL Policies. *Id*. at *5.

Citing to *U.S. Metals, Inc. v. Liberty Mut. Group, Inc*., 490 S.W.3d 20, 29 (Tex. 2015), and *Lennar Corp. v. Markel Insurance American Insurance Co*., 13 S.W.3d 750, 757 (Tex. 2013), the court

noted that the Supreme Court of Texas had determined that repair costs and other damages to access faulty equipment installed by an insured was "property damage" under nearly identical CGL policy language. *Cruz*, 2017 WL 5202891 at *5. Accordingly, the Court found that D&D experienced "property damage" sufficient to implicate coverage.

C. Was there an "Occurrence"?

Travelers argued that D&D's "property damage" was not caused by an "occurrence" because there was no "accident." Rather, the damage was a result of D&D's intentional activities to repair Cruz's defective work. *Id*. The Court found that Travelers' argument was misplaced because the relevant inquiry was not whether D&D's repair activities were intentional, but rather whether the damage resulting from Cruz's negligence was "unexpected and unintended, and therefore accidental." *Id*. (citing *Hartford Cas. Co. v. Cruse*, 938 F.2d 601, 605 (5th Cir. 1991)). The court noted that the Fifth Circuit "has held that defective performance or faulty workmanship by the insured that injures the property of a third party is 'accidental' under this definition." *Id*. at *6 (citing *Federated Mut. Ins. Co. v. Grapevine Excavation, Inc*., 197 F.3d 720, 725 & nn. 20, 23 (5th Cir. 1999); *Cruse*, 938 F.2d at 604–05; *First Tex. Homes, Inc. v. Mid-Continent Cas. Co*., No. 3-00-CV-1048-BD, 2001 WL 238112, at *2–3 (N.D. Tex. Mar. 7, 2001)). Further, "an occurrence takes place where the resulting injury or damage was unexpected and unintended, regardless of whether the policyholder's acts were intentional." *Id*. (quoting *Cruse*, 938 F.3d at 605). Accordingly, since the property damage at issue occurred with the failed testing of the utility systems, the court found that such damage was unexpected and unintended and, therefore, constituted an "occurrence" under the policies. *Id*.

Travelers also argued that any such "occurrence" did not take place during its policy periods but occurred sometime after Cruz had finished its work on the project. *Id*. The court rejected this argument based on the Supreme Court of Texas's holding in *Don's Building Supply, Inc. v. OneBeacon Insurance Co*., 267 S.W.3d 20, 30 (Tex. 2008), that "[o]ccurred means when *damage* occurred, not when *discovery* occurred." 2017 WL 5202891, at *6 (emphasis in original). Because the underlying petition alleged damage occurring during the policy period, there was sufficient evidence that the property damage at issue was an "occurrence" to avoid summary judgment.

D. Application of Policy Exclusions

Having agreed that the requirements of the insuring agreement had been met, the court addressed whether the policy exclusions for "damage to property" and "impaired property" barred coverage for the damage resulting from Cruz's defective work.

i. "Damage to Property" Exclusions

Exclusion j.(5) applies 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 noted that Texas courts have determined that "the use of the present tense indicates that the exclusion applies to circumstances where the contractor or subcontractors are currently working on the project." *Id*. at *7 (quoting *CU Lloyd's of Tex. v. Main St. Homes, Inc*., 79 S.W.3d 687, 696 (Tex. App.—Austin 2002, no pet.); *see also Mid–Continent Cas. Co. v. JHP Dev., Inc*., 557 F.3d 207

(5th Cir. 2009)). Because the underlying petition did not allege that Cruz currently was working on the project, the court found that exclusion j.(5) did not apply.

Exclusion j.(6) provides that there is no 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." However, the exclusion does not apply to "property damage" included in the "products-completed operations hazard." The court noted that the Fifth Circuit has held that:

> the plain language of the exclusion "bars coverage only for property damage to parts of a property that were themselves the subject of defective work by the insured; 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. (citing *JHP Dev., Inc*., 557 F.3d at 215). Because D&D and Cruz were not claiming coverage for the cost to repair Cruz's work itself, the court concluded that exclusion j.(6) did not bar coverage for the damages being claimed.

ii. "Impaired Property" Exclusion

The "impaired property" exclusion bars coverage for claims arising out of damages to impaired property – property that can be "restored to use by the … repair, replacement, adjustment or removal" of the defective utilities. *Id*. at *8. The court found that for the exclusion to apply, the electric utility lines, roads, curbs and parkways that were damaged as a result of Cruz's work would need to be capable of being fully restored by repairing Cruz's work. *Id*. In other words, the damage would be entirely repaired by simply fixing Cruz's work. However, the court noted that nothing in the court's record or in the underlying pleadings demonstrated that such a solution would actually repair the damage caused to the electric utility lines, roads, curbs and parkways. Accordingly, the damage being claimed was not to "impaired property" to which the exclusion applied.

E. Attorneys' Fees

The judgment in the underlying case awarded over $300,000 in attorneys' fees to D&D. Travelers argued that attorneys' fees are not "damages" that are covered by CGL policies. *Id*. at *9. D&D and Cruz argued that the word "damages" is undefined in the policies and that it should be given its normal meaning and should not be precluded from coverage. *Id*. Citing the Supreme Court of Texas's opinions in *In re Nalle Plastics Family Ltd. Partnership*, 406 S.W.3d 168 (Tex. 2013) (finding that "compensatory damages" do not include attorneys' fees in the context of superseding a judgment), and *In re Corral-Lerma*, 451 S.W.3d 385 (Tex. 2015) (per curiam) ("while attorney's fees for the prosecution or defense of a claim may be compensatory in that they help make a claimant whole, they are not, and have never been, damages"), the court found that summary judgment should be granted to Travelers.

F. Commentary

In *Cruz*, following the Supreme Court of Texas's decision in *U.S. Metals*, the court found that the costs to access an insured's defective work could constitute independent "property damage"

sufficient to trigger coverage under a commercial general liability policy. Further, the court found that allegations of damage to property other than to the defective work itself was sufficient to avoid the application of the "damage to property" and "impaired property" exclusions. Interestingly, the court applied a duty to defend standard—*i.e.*, the court looked to only the pleadings and the terms of the insurance policy—when evaluating the extent to which the carrier owed a duty to indemnify. Applying this standard, the court ultimately found that the *pleadings* were sufficient to overcome summary judgment despite the fact that the duty to indemnify is inherently an issue of fact. The case settled prior to an appeal to the Fifth Circuit. As such, this will not be the last word on the scope and application of *U.S. Metals* for "rip and tear" coverage.

VII. *Lyda Swinerton Builders, Inc. v. Oklahoma Surety Co.*, 903 F.3d 435 (5th Cir. 2018)

Following the Supreme Court of Texas's opinion in *USAA Texas Lloyds Co. v. Menchaca*, 545 S.W.3d 479 (2018), the Fifth Circuit, in *Lyda Swinerton Builders, Inc. v. Oklahoma Surety Co*., 903 F.3d 435 (5th Cir. Aug. 29, 2018), recently addressed an insurer's duty to defend and the damages an insured may recover when the duty is breached.

A. Background Facts

Lyda Swinerton Builders was hired as the general contractor to build a ten-story office building in College Station, Texas. Swinerton engaged A.D. Willis Company as a subcontractor for roofing, ornamental metal, metal wall panels, and rough carpentry. As a requirement under the subcontract, Willis obtained a commercial general liability policy from Oklahoma Surety Company ("OSC") in which Willis was identified as a "ROOFING CONTRACTOR" and Swinerton was named an additional insured "but only with respect to liability directly attributable to performance of 'your [*i.e.*, Willis'] work.'" *Id*. at 441.

After the office building owner assigned its interest in the contract with Swinerton to Adam Development Properties ("ADP"), ADP sued Swinerton for breach of contract, alleging, among other things, that Swinerton failed to meet the contractual deadline for substantial completion, provided work with material deficiencies and consistently failed to comply with various contractual obligations (*e.g.*, adequately supervise its subcontractors, provide skilled workers and suitable materials, protect the property from exposure to the elements). *Id*. at 442. Swinerton filed a third-party petition against Willis and others. When ADP amended its petition, it referred to Willis as a third-party defendant (without mentioning it was a subcontractor).

Swinerton requested a defense from OSC based on its status as an additional insured under Willis' policy, which OSC denied. Swinerton also requested a defense from other insurers (some of whom issued policies directly to Swinerton), who similarly denied the request. One of the insurers that denied Swinerton's request filed a declaratory judgment action in a federal district court, naming ADP, Swinerton and another party as defendants. Swinerton filed a third-party complaint in that action, seeking damages and relief against OSC and the other insurers for breach of contract based on their failure to defend in the state court suit, violation of the Texas Insurance Code and violation of the Prompt Payment of Claims Act.

All claims eventually settled with the exception of those between Swinerton and OSC. The District Court ultimately found OSC had a duty to defend Swinerton, that the duty was breached and that

Swinerton was entitled to damages. The District Court awarded approximately $650,000 for the breach of the duty to defend and violation of the Prompt Payment of Claims Act, statutory penalty of 18% interest, and reasonable attorneys' fees and costs. *Id*. at 444.

B. Did OSC Owe a Duty to Defend?

Addressing OSC's duty to defend, the court analyzed the duty in three parts: (1) whether Swinerton was a named insured under the OSC policy; (2) whether a duty to defend arose under the eight-corners rule; and (3) whether the anti-stacking rule applied.

The court noted that the policy obligated OSC to defend Willis and any additional insured against suits covering property damage covered by the policy provided that Willis "agreed by written 'insured contract' to designate" Swinerton as an additional insured. *Id*. at 445. Despite the fact that Swinerton never countersigned the subcontract, the court found that the subcontract between Swinerton and Willis qualified as an "insured contract" because even with certain modifications to the subcontract's indemnity agreement, the subcontract still provided that Willis agreed to "unconditionally indemnify" Swinerton "to the fullest extent permitted by law." *Id*. at 446. The court also held that a party may qualify as an additional insured even if the underlying insured contract is not enforceable. *See id.*

Under the eight-corners rule, Texas courts look to the facts alleged within the four corners of the petition (or complaint) in the underlying lawsuit, "measure them against the language within the four corners of the insurance policy, and determine if the facts alleged present a matter that could *potentially* be covered by the insurance policy." *Id*. (citing *Ewing Constr. Co. v. Amerisure Ins. Co*., 420 S.W.3d 30, 33 (Tex. 2014)) (emphasis added by court). The court found that the allegations in the underlying petition were sufficient to implicate OSC's duty to defend. Specifically, the court found that, based on the factual allegations of material deficiencies in the work resulting from actions by contractors and deficiencies in the building's roof, the petition sufficiently alleged damage caused by Willis even though Willis was not specifically named in the petition.

The court then turned to *American Physicians Insurance Exchange v. Garcia*, 876 S.W.2d 842 (Tex. 1994), in which the Supreme Court of Texas adopted an "anti-stacking rule" that prohibits an insured from stacking the coverage limits of multiple, consecutive policies when "a single claim involving indivisible injury" extends across several distinct policy periods. *Id*. at 449 (quoting *Garcia*, 879 S.W.2d at 853-55). OSC argued that, because Swinerton obtained a complete defense from another insurer, to allow it to recover from OSC as well would undermine the anti-stacking rule. *Id*. Because *Garcia* was an indemnity case, the court questioned whether the anti-stacking rule even applied in the duty to defend context. *Id*. The court then found that, even if the rule did apply to duty to defend cases, it would not apply to Swinerton's claim. In particular, the court noted that OSC had not presented any evidence that Swinerton obtained a complete defense from the other carrier before requesting a defense from OSC. *Id*. To allow OSC to avoid its obligation to defend because Swinerton was able to obtain a defense elsewhere, after OSC shirked its legal duty, would "incentivize wrongful denials of requests of defense and would shift defense costs onto insurers who undertake their duty to defend in good faith." *Id*.

Based on the above, the Fifth Circuit affirmed the District Court's finding that there was a duty to defend.

C. Did OSC Violate Chapter 541 of the Texas Insurance Code?

Swinerton claimed OSC violated the Texas Insurance Code by knowingly misrepresenting the policy coverage to avoid its duty to defend. *Id*. at 451. The District Court found that Swinerton provided no evidence that it suffered an independent injury apart from the denial of policy benefits and, therefore, ruled in favor of OSC. *Id*. While the case was on appeal, the Supreme Court of Texas issued its opinion in *USAA Texas Lloyds v. Menchaca*.

The *Menchaca* court distilled several rules regarding the relationship between contractual and extra-contractual claims—including the "entitled-to-benefits rule" and the "independent injury rule." *Id*. (citing *Menchaca*, 545 S.W.3d at 489). The "entitled-to-benefits" rule provides that "an insured who establishes a right to receive benefits under an insurance policy can recover those benefits as 'actual damages' under the [Insurance Code] if the insurer's statutory violation causes the loss of the benefits." *Id*. (citing *Menchaca*, 545 S.W.3d at 495). The "independent injury" rule has two aspects:

> The first is that, if an insurer's statutory violation causes an injury independent of the insured's right to recover policy benefits, the insured may recover damages for that injury even if the policy does not entitle the insured to receive benefits. ... The second aspect of the independent-injury rule is that an insurer's statutory violation does not permit the insured to recover any damages beyond policy benefits unless the violation causes an injury that is independent from the loss of the benefits.

Id. (citing *Menchaca*, 545 S.W.3d at 499–500).

The court noted that, because the "entitled-to-benefits" rule allows an insured to recover policy benefits as "actual damages" and an insured can recover treble damages in the event an insurer knowingly committed the act complained of, an insured can recover three times the amount of policy benefits. *Id*. at 453. Because Swinerton was entitled to a defense from OSC as a benefit of the OSC policy, if Swinerton could establish, on remand, that the misrepresentation caused the loss of the benefit, Swinerton can recover the defense costs it incurred as actual damages plus treble damages upon a finding that the statutory violation was made knowingly. *Id.*

D. Swinerton's Damages

OSC also appealed the district court's award of defense costs to Swinerton. The Fifth Circuit found no error because those defense costs were damages produced by OSC's breach of its duty to defend. *Id*. at 453–54. For damages under the prompt payment statute, because of the remand of Swinerton's claims under Chapter 541 of the Insurance Code, the Fifth Circuit noted that, if Swinerton prevails and elects to recover defense costs as actual damages rather than breach-of-contract damages, it will be entitled to recover penalties under the prompt payment act through the time of the judgment in the remanded action. *Id*. at 455–56.

E. Commentary

The Fifth Circuits decision in *Swinerton* reinforces how broadly the duty to defend applies in Texas. In fact, the court started with the notion that the eight-corners rule is "very favorable to insureds."

The *Swinerton* decision is most notable, however, for its discussion of Chapter 541 and its application of the Supreme Court of Texas's analysis in *USAA Texas Lloyds v. Menchaca*. In particular, the application of *Menchaca*—a first-party property insurance case—to a third-party liability case is noteworthy. In doing so, for the first time under Texas law, the court found that Swinerton was entitled to recover the attorneys' fees it incurred to defend itself in the underlying litigation and statutory penalties but also that it may be entitled to *treble* damages in the event it can show—on remand—that OSC knowingly misrepresented the coverage under its policy in order to avoid the duty to defend.

Recently, in *Braden v. Allstate Vehicle & Property Insurance Co.*, No. 18-592, 2019 WL 201942 (N.D.Tex. Jan 15, 2019), the Northern District of Texas cited *Swinerton* for the proposition that the "independent injury" rule does not restrict the damages an insured can recover under the "entitled-to-benefits" rule; rather the "independent-injury" rule restricts the recovery of *other* damages that flow from a denial of policy benefits. For example, an insured is not entitled to recover damages for emotional distress caused by a denial of benefits because "the entitled-to-benefits doctrine does not provide for the recovery of such damages and . . . the second aspect of the independent-injury rule precludes such recovery." *Swinerton*, 903 F.3d at 452. Simply put, *Swinerton* already is being applied by other courts and will be oft-cited in the near future—or at least until the Supreme Court of Texas gets an opportunity to address the applicability of Chapter 541 to a liability insurance policy.

VIII. Honorable Mention:

A. The "Extrinsic Evidence" Exception to the "Eight Corners" Rule: *Evanston Insurance Co. v. Kinsale Insurance Co*., No. 17-327, 2018 WL 4103031 (S.D. Tex. July 12, 2018)

VCC, LLC filed suit against Pharr-San Juan-Alamo Independent School District ("PSJA") for nonpayment. PSJA then filed a counterclaim against VCC, alleging defective work by VCC and its subcontractors. In turn, VCC filed cross-claims and a third-party petition against its subcontractors—including NM Contracting, LLC ("NM"). Both Evanston and Kinsale initially provided a defense to NM against the claims by VCC.

According to VCC's crossclaim, one of the construction projects began in 2011 and ended in 2012, and the other began in 2009 and ended in 2011. The complaint, however, was silent as to when the property damage occurred. Eventually, one of the carriers (Kinsale) withdrew its defense and denied that it owed any defense obligation because the damage arose before its coverage existed. Kinsale relied on a "prior injury or damage" exclusion in its policy to deny coverage. Evanston then brought suit, seeking a declaration that Kinsale did owe a duty to defend and to recover Kinsale's share of the defense costs.

At issue was whether the court was required to determine whether Kinsale owed a duty to defend by only looking at the allegations in VCC's crossclaim or whether the allegations in PSJA's counterclaim regarding when property damage occurred could be considered. The court noted the following:

> Texas courts have recognized "a very narrow exception" to the eight-corners rule that permits the "use of extrinsic evidence only when relevant to an independent and discrete coverage issue, not touching on the merits of the underlying third-party claim." This exception applies "when it is initially impossible to discern whether coverage is potentially implicated and when the extrinsic evidence goes solely to a fundamental issue of coverage which does not overlap with the merits of or engage the truth or falsity of any facts alleged in the underlying case."

Id. at *10 (citing *GuideOne Elite Ins. Co. v. Fielder Rd. Baptist Church*, 197 S.W.3d 305, 308–09 (Tex. 2006)).

The court discussed why the PJSA counterclaim fell within the extrinsic evidence exception as follows:

> [T]he Court also agrees with Defendant that this is a situation in which the extrinsic evidence exception applies. The alleged date of construction goes solely to a fundamental issue of coverage and does not implicate the merits or depend on the truth of the facts alleged. [Evanston] argues that the extrinsic evidence exception would not apply because the Court may not consider a complaint as evidence of the truth of an assertion since the facts asserted in pleadings do not constitute evidence. However, the Court is not referring to the PSJA Counterclaim as evidence of the truth of the dates of construction, but rather as evidence of what allegations were made in the PSJA Counterclaim regarding the dates of construction. Thus, the pleading itself is the evidence, and would fall within the extrinsic evidence exception.

Id. at *11 (citing *Weingarten Realty Mgmt. Co. v. Liberty Mut. Fire Ins. Co*., 343 S.W.3d 859, 862–64 (Tex. App.—Houston [14th Dist.] 2011, pet. denied) (discussing the application of the exception)). Based on the allegations at issue, the court concluded that PSJA alleged damage that occurred prior to the inception of the Kinsale policy and, therefore, Kinsale had no duty to defend.

B. Application of a "Cross-Suits" Exclusion: *Certain Underwriters at Lloyd's of London v. Sterling Custom Homes, Inc.*, 705 F. App'x 259 (5th Cir. 2017) (not designated for publication).

Sterling Custom Homes, Inc. was the general contractor on a residential construction project that subcontracted with Silvestre Espinoza's painting company. The subcontract required Espinoza to obtain commercial general liability insurance and name Sterling as an additional insured. Espinoza purchased coverage from Lloyds, and the policy contained an additional insured endorsement that

extended blanket additional insurance coverage to other entities "as per written contract." *Id*. at 261.

When a fire damaged the construction project, Sterling's builder's risk insurers paid for the loss and then brought a subrogation action in Sterling's name against Espinoza. The Lloyd's Syndicate filed a declaratory judgment action in federal court, seeking a declaration that the policy's cross-claim exclusion applied and no duty to defend existed because one insured under the policy brought suit against another insured, triggering the exclusion.

The *Sterling* court found that the exclusion was enforceable as written. *Id*. at 264. The court then turned to whether Sterling was an additional insured when it sued Espinoza. The court noted that the policy's additional insured endorsement added specific entities as additional insureds "but only with respect to liability arising out of your [*i.e.*, Espinoza's] ongoing operations performed for that insured." *Id*. at 265. Thus, the court found that the additional insured endorsement made Sterling an additional insured only with respect to Sterling's liability arising out of Espinoza's ongoing operations for Sterling. *Id*. The court explained its conclusion as follows:

> The plain language of the additional insured endorsement comports with our interpretation, and we conclude our interpretation most likely reflects the parties' true intentions. For example, our interpretation recognizes the likelihood that Espinoza, the policy's purchaser, intended to buy from the Syndicate a commercial general liability policy that provided him coverage for claims made against him by his general contractors. Similarly, nothing in the plain language of the subcontracting agreement obligating Espinoza to name Sterling Homes as an additional insured suggests the parties intended for Espinoza to lose insurance coverage in the event Sterling Homes needed to sue him.

Id. Because Sterling was not an additional insured with respect to the subrogation action at issue, the Fifth Circuit found that the district court had erred when finding that the cross-suits exclusion barred coverage. *Id*.

C. Allegations of "Property Damage": *Scottsdale Insurance Co. v. Mid-Continent Casualty Co.*, No. 17-191, 2018 WL 5733179 (W.D. Tex. July 5, 2018).

Scottsdale provided liability insurance coverage to Templar Development, Inc. from 2009-2016 and provided Templar with a defense when suit was filed against it by a condominium association for alleged construction deficiencies. Mid-Continent provided coverage to Templar from 2004-2006 and it refused to provide a defense to Templar for the condominium association's claim. Scottsdale filed suit against Mid-Continent in federal court, seeking a declaration that Mid-Continent owed a duty to defend and for contribution.

The underlying complaint generally alleged deficiencies in the "construction of the Project's roofs, exterior cladding, concrete flatwork, windows, doors, parking areas, exterior stairways, grading and drainage." *Id*. at *4. As a result, the condo association claimed "damages including, but not limited to, property damage, diminution in value, repair costs, mitigation costs, loss of use of all or portions of the Project, attorney's fees, litigation costs, and other damages." *Id*.

Initially, the court examined whether the allegations alleged "property damage." Mid-Continent argued that the allegations were conclusory in nature and, therefore, insufficient to invoke coverage. *Id*. at *5 (citing *PPI Tech. Servs., L.P. v. Liberty Mut. Ins. Co*., 515 F. App'x 310, 314 (5th Cir. 2013) (not designated for publication) (holding no coverage existed because the underlying complaint "did not contain factual allegations of property damage" because "the underlying complaints contain no factual allegations of actual damage to or loss of tangible property. The allegations in the underlying lawsuits are either for economic damages, and thus not covered, or are legal conclusions, rather than factual allegations as required."). Conversely, Scottsdale relied on *Lexington Insurance Co. v. National Oilwell NOV, Inc*., 355 S.W.3d 205 (Tex. App.—Houston [1st Dist.] 2011, no pet.), which imposed a duty to defend based on "scantily pleaded allegations." *Scottsdale*, 2018 WL 5733179 at *5. Ultimately, the court found that the underlying allegations were no less descriptive than those in *National Oilwell* and, therefore, were sufficient to allege "property damage." *Id*. at *6.

The court then examined whether the policy's exclusions for damage to Templar's work barred coverage. Based on the broad allegations in the underlying petition, the court found that damage to property outside Templar's work potentially had been alleged. *Id*. at *7. Accordingly, the exclusions did not apply. Similarly, the "impaired property" exclusion did not preclude a duty to defend because the court found that the underlying petition potentially alleged damages to aspects of the project outside the scope of Templar's work, and no allegations existed that those aspects "incorporated" Templar's work such that they became "impaired property."

IX. Case to Watch: *PSI vs. Mid-Continent*: Cooperation Clause and Coverage for Attorneys' Fees

"This insurance coverage case raises various legal issues suitable for a law school examination." That is the first sentence of *Mid-Continent Casualty Co. v. Petroleum Solutions, Inc.*, No. CV 4:09-0422, 2016 WL 5539895, at *1 (S.D. Tex. Sept. 29, 2016), *amended,* CV 4:09-0422, 2016 WL 7491858 (S.D. Tex. Dec. 30, 2016), an opinion spanning more than ninety pages and, if affirmed on appeal, will have a significant impact on (1) how the duty to cooperate applies in the context of general liability coverage in Texas and (2) whether there is general liability coverage for a claimant's attorneys' fees as "damages because of . . . 'property damage.'" The Fifth Circuit heard oral argument on these issues on January 7, 2019.

A. Background Facts

The facts in this case span nearly two decades and include a jury trial in the underlying liability lawsuit, an appeal to the Corpus Christi Court of Appeals, an appeal to the Supreme Court of Texas, a hearing in the trial court on remand, and a coverage dispute in the Southern District of Texas, lasting more than eight years. The background facts here are taken almost verbatim from the district court's Amended Memorandum and Order issued September 29, 2016. *Id*. at *2.

In 1997, Bill Head ("Head") contracted with Petroleum Solutions, Inc. ("PSI") to construct and install an underground fuel storage system at his Silver Spur Truck Stop ("Silver Spur") in Pharr, Texas. PSI purchased a component part for the fuel tank from Titeflex Commercial Products ("Titeflex"). In October 2001, Head discovered that 20,000 gallons of diesel fuel had seeped into the soil under the truck stop. Head attributed the damage to a leak in the fuel storage system and

contacted PSI. PSI notified Mid-Continent Casualty Company ("Mid-Continent") of the fuel spill, believing any resulting liability would be covered by the commercial general liability policy Mid-Continent issued to PSI (the "Policy"). *Id*.

In 2002, Mid-Continent retained counsel to represent PSI in any potential litigation arising out of the fuel leak. PSI and Mid-Continent believed that a flex connector manufactured by Titeflex in the fuel tank was faulty. Counsel submitted the flex connector to an expert for testing. The expert inspected the flex connector but found no visual, conclusive evidence that the part was defective. The expert stored the flex connector in W.H. Laboratories' storage facility, which was torn down in 2006, causing the part to be lost. *Id*. at *3.

On February 13, 2006, more than four years after the leak was discovered, Head filed suit against PSI (the "State Court Litigation"). Head alleged claims for Breach of Warranty of Fitness, Breach of Implied Warranty of Good and Workmanlike Services, and Negligence. Head alleged that PSI had contended that the fuel leak was caused by a faulty flex connector, but the Original Petition alleged more broadly that PSI was at fault because it sold and installed the fuel storage tank, including the flex connectors and the leak detection system. Mid-Continent assumed PSI's defense under a reservation of rights. *Id*.

On October 5, 2006, PSI filed a third-party action against Titeflex, in which it alleged that Titeflex was responsible for the failure of the fuel storage system and, therefore, PSI was "entitled to contribution and/or indemnity" from Titeflex (the "Affirmative Claim") under the Texas Products Liability Act, specifically, § 82.002 of the Texas Civil Practice and Remedies Code ("Section 82.002"). Several months later, on January 30, 2007, Head filed a First Amended Original Petition, which added a strict products liability claim against Titeflex. *Id*.

During discovery in the State Court Litigation, on January 4, 2008, Titeflex moved for a spoliation instruction against PSI for PSI's failure to produce the flex connector. On March 7, 2008, Head non-suited his claims against Titeflex without prejudice and shortly thereafter filed an amended petition that alleged claims only against PSI. *Id*.

In the first half of 2008, PSI and Mid-Continent debated whether to dismiss PSI's Affirmative Claim against Titeflex. Mid-Continent had retained trial counsel to represent PSI in the trial court and appellate counsel to prepare for the possibility of an appeal. Appellate counsel also offered legal advice during the trial court proceedings. After Head non-suited his claims against Titeflex without prejudice, trial counsel advised that PSI similarly should dismiss its Affirmative Claim without prejudice to simplify the State Court Litigation because Titeflex was "vigorously defending itself," and the defense was undercutting PSI's position with regard to Head. *Id*. at *4.

On May 19, 2008, Titeflex filed a counterclaim against PSI (the "Titeflex Counterclaim") requesting indemnification of "costs of court, reasonable expenses, and attorney's fees arising subsequent to the entry of [Head's] Notice of Non-Suit [on March 7, 2008] which were expended in defense of this action and in prosecution of this demand for indemnity." PSI's trial counsel relayed to Mid-Continent and PSI that Titeflex offered to dismiss its Counterclaim if PSI dismissed its Affirmative Claim. As a result, on August 12, 2008, PSI dismissed its Affirmative Claim

without prejudice. On August 13, 2008, Titeflex explained that it only would dismiss its Counterclaim if PSI would agree to mutual dismissal of their claims *with* prejudice (the "Settlement Offer"). Titeflex gave PSI two days, until August 15, 2008, to accept the Settlement Offer. *Id*.

PSI's trial counsel advised Mid-Continent and PSI that PSI's dismissal of its claims against Titeflex likely disposed of the Titeflex Counterclaim because it was merely a reformulation of Titeflex's Answer to PSI's Affirmative Claim. Nevertheless, Titeflex maintained that its Counterclaim remained valid despite PSI's dismissal. PSI's trial counsel, as well as Mid-Continent personnel, urged PSI to accept the Settlement Offer. PSI decided to reject the Settlement Offer because PSI wanted to retain the option to pursue an indemnity action against Titeflex, if necessary, in light of Mid-Continent's reservation of rights regarding the defense of PSI against Head's claims. *Id*.

On September 15, 2008, a month after Titeflex's Settlement Offer had expired, Titeflex amended its counterclaim. As amended, the Titeflex Counterclaim asserted a Section 82.002 claim, which requested "all past and future costs of court, reasonable expenses, and reasonable and necessary attorney's fees which were expended in defense of this action and in prosecution of this demand for indemnity." *Id*. at *5

The State Court Litigation proceeded to trial on Head's and Titeflex's respective claims against PSI. The judge instructed the jury that PSI had "destroyed, lost, or failed to produce . . . material evidence" and that the jury could presume that this evidence was unfavorable to PSI. The jury returned verdicts in favor of Head and Titeflex. Head was awarded $1,131,321.26 in damages and prejudgment interest and $91,500.00 in attorney's fees against PSI. The jury awarded Titeflex $382,334.00 in attorneys' fees, $68,519.12 in expenses, $12,393.35 in costs, and post-judgment interest at 5% from the day of the judgment until its satisfaction (the "Titeflex Judgment"). *Id*.

PSI appealed the judgment in favor of Head, contending that the trial judge's spoliation sanctions were in error. PSI also appealed the Titeflex Judgment on the ground that Titeflex could not satisfy the requirements of Section 82.002, the statute pursuant to which it sought indemnification from PSI. The Corpus Christi Court of Appeals affirmed, and PSI petitioned for review by the Supreme Court of Texas. The Court issued an opinion on July 11, 2014, but substituted a new opinion on reconsideration on December 19, 2014. The Court reversed the judgment in favor of Head, holding the trial court's spoliation instruction was error, and remanded for retrial on Head's claims. At the same time, the Court rejected PSI's challenges to the Titeflex Judgment, finding that the erroneous spoliation instruction did not affect the verdict in favor of Titeflex. Accordingly, the Court affirmed the Titeflex Judgment. In June of 2016, on remand, the trial court entered summary judgment for PSI on Head's claims. *Id*.

Over the course of the State Court Litigation, Mid-Continent sent six reservation of rights letters to PSI—the fifth and sixth of which are relevant in the coverage case. The fifth letter, which was sent on August 26, 2008, did not address the Titeflex Counterclaim specifically, but stated that "Mid-Continent reserves its right to decline any duty to PSI, including, but not limited to, PSI's failure to cooperate in our investigation and defense of this claim/suit." In the sixth letter, sent on

September 19, 2008, Mid-Continent explained that its coverage position in the fifth letter applied to the Titeflex Counterclaim. Noting that Titeflex sought indemnification only of attorney's fees, costs of court, and reasonable expenses, Mid-Continent reserved the right in the sixth letter to disclaim coverage because these items "may not constitute damages because of 'property damage' or 'bodily injury' caused by an 'occurrence' as defined by the Mid-Continent Policy." *Id*. at *6.

After the Supreme Court of Texas affirmed the Titeflex Judgment in its July 11, 2014 opinion, Mid-Continent denied coverage for the Titeflex Counterclaim on July 30, 2014. In the denial letter, Mid-Continent took the position that PSI's rejection of the Settlement Offer constituted a failure of cooperation that permitted Mid-Continent to deny coverage. Mid-Continent further cited "Exclusion q" of the Policy, which excludes losses "caused intentionally by or at the direction of the insured." *Id*.

On February 12, 2009, Mid-Continent filed a declaratory judgment action in the United States District Court for the Southern District of Texas seeking declaratory relief that the judgment against PSI in the State Court Litigation was not covered under the Policy. *Id*. Mid-Continent sought a declaratory judgment that the Titeflex Judgment is not covered by the Policy on the grounds that (1) the language of the Policy does not support a finding of coverage, (2) Exclusion q applies to the Titeflex Judgment, and (3) PSI breached its duty to cooperate with Mid-Continent when PSI rejected the Settlement Offer. PSI counterclaimed on the grounds that Mid-Continent's denial of coverage constituted (1) a breach of contract and (2) a breach of Chapter 541 of the Texas Insurance Code. PSI and Mid-Continent filed cross-motions for summary judgment. *Id*. The case was ultimately tried to a jury, which found that PSI had complied with the cooperation clause with respect to the Titeflex Settlement Offer and that Mid-Continent had nonetheless waived its right to enforce the cooperation clause.

B. The Duty to Cooperate Encompassed PSI's Decision whether to Settle its Affirmative Claim and was a Fact Issue for the Jury

Mid-Continent complained that PSI failed to satisfy its contractual duty to cooperate by refusing to acquiesce to Mid-Continent's request to agree to the Settlement Offer and dismiss its Affirmative Claim with prejudice. PSI, on the other hand, argued that the dismissal of the Affirmative Claim would have been a bad bargain considering the legal advice of trial counsel and appellate counsel and the fact that Mid-Continent had issued a reservation of rights, potentially leaving Titeflex as the only source of indemnification for Head's claim. Moreover, PSI argued that the application of the duty to cooperate to an insured's affirmative claim would be an "unprecedented expansion of the duty." *Id*. at *14.

The duty to cooperate is contractual and states in pertinent part that the insured must "[c]ooperate with [the insurer] in the investigation or settlement of the claim or defense or defense against the 'suit'[.]" "Claim" means a request for relief against the insured. "'Suit' means a civil proceeding in which damages because of 'bodily injury', 'property damage' or 'personal and advertising injury' to which [the] insurance applies are alleged." Accordingly, the court stated that "[b]ecause 'suit is defined to include the entire 'civil proceeding,' the assertion of, or retention of a right to assert, a right of action by PSI in response to a claim against it is part of 'defense against' a 'suit'

under the Policy." *Id*. In doing so, the court rejected PSI's textual argument that the term "settlement of *the* claim" in the cooperation clause limited its scope to purely defensive actions. Instead, the court stated that the whole clause must be read in light of the broad definition of "suit," which includes the entire "civil proceeding." As the Affirmative Claim was an item of value that could be used "as a part of a 'settlement of the claim,'" the court held that the cooperation clause applied to PSI's rejection of the Settlement Offer. *Id*. at *14-*15.

Having decided the cooperation clause applied, the court then held that neither party carried its burden to show the absence of a genuine issue of material fact "regarding the reasonableness of PSI's rejection of the Settlement Offer." *Id*. at *16. The court found that the record contained support for both PSI's and Mid-Continent's positions. As such, the court denied both parties' motions for summary judgment on the cooperation clause. The court, however, did find as a matter of law that, if a jury finds PSI acted unreasonably, Mid-Continent was prejudiced by PSI's rejection of the Settlement Offer because PSI "deprived Mid-Continent of the opportunity to avoid liability entirely." *Id*. at *19.

C. Coverage for an Attorneys' Fee Award under the Insuring Agreement

The scope of commercial general liability coverage for bodily injury and property damage is established by the Policy's "Insuring Agreement" at section I.A.(1)(a):

> We [Mid-Continent] will pay those sums that the insured [PSI] becomes legally obligated to pay as damages because of 'bodily injury' or 'property damage' to which this insurance applies.

To carry its burden with respect to coverage on summary judgment, PSI had to show that there was no genuine issue of material fact that (1) there was "'property damage' to which this insurance applies" and (2) the Titeflex Judgment was awarded as "damages because of" that property damage." The court found that the damage to Head's property resulting from the 20,000 gallons of leaked diesel established "property damage." *Id*. at *21–*26.

With regard to whether there were "damages because of property damage," the court had a mixed answer based on its analysis of the components of the Titeflex Judgment. The court first looked at what constitutes damages, distinguishing between compensatory and non-compensatory damages as explained in *In re Nalle Plastics Family Limited Partnership*, 406 S.W.3d 168, 171 (Tex. 2013). The court held that Titeflex's Section 82.002(a) award constituted damages because they were compensation. In contrast, Titeflex's Section 82.002(g) award for costs incurred in prosecuting its indemnification claim against PSI were non-compensatory because 82.002(g) is a "fee-shifting provision for successful claims against a product manufacturer" and, as such, are not damages "because of property damage" under the Policy. *Id*. at *26–*37.

D. Commentary

The jury favorably answered both questions for PSI, finding that PSI had cooperated and, in any event, Mid-Continent waived its right to raise cooperation as a defense because of deficiencies in

reservation of rights letters as well as actions that were inconsistent with the reservations. Despite this favorable outcome, PSI appealed the decision to seek a finding that an insured cannot violate the duty to cooperate by refusing to release an affirmative claim at the carrier's request, especially when the carrier has reserved the right to deny coverage. Even if the Fifth Circuit rules that the cooperation clause applies to an affirmative claim, it will then have to address the standard for cooperation as well as the issue of waiver. Further, the court's decision denied coverage for attorneys' fees awarded to a claimant under a fee-shifting statute, clearly calling into question the availability of coverage for an award of attorneys' fees under Chapter 38.001 of the Texas Civil Practice and Remedies Code as "damages because of . . . 'property damage.'" In particular, for PSI, that decision significantly reduced its damages. The ultimate conclusions on the issues—the application of the cooperation clause to an insured's affirmative claims and attorneys' fees as "damages because of . . . 'property damage'"— will likely reverberate for years to come.

While the issue of applying the cooperation clause to an affirmative claim appears to be one of first impression across the country, the issue of whether coverage exists for attorneys' fees awarded to a claimant is one that is being hotly contested with at least two district court opinions in Texas following the district court's decision in *PSI* and holding that attorneys' fees awarded pursuant to C.P.R.C. 38.001 are not "damages" and are therefore not covered. As noted in Section III. above, the Fifth Circuit—in a footnote—also indicated that it may rely on *In re Nalle* for this conclusion. *See Satterfield & Pontikes Constr., Inc. v. United States Fire Ins. Co.*, 898 F.3d 574, 576 n.2. (5th Cir. 2018). PSI, in turn, argued that the footnote was not binding as it was in the factual background portion of the opinion as opposed to the legal analysis portion. It is likely that the Fifth Circuit will put the issue to rest in *PSI.* If the Firth Circuit rules that attorneys' fees awarded pursuant to a fee-shifting statute are not covered, it will result in a potentially large gap in coverage for any insured sued under a breach of contract theory. Stay tuned.