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

THE POLICYHOLDERS' PERSPECTIVE

LEE H. SHIDLOFSKY
Visser Shidlofsky LLP
7200 N. Mopac Expy., Suite 430
Austin, Texas 78731
lee@vsfirm.com

22ND ANNUAL
CONSTRUCTION LAW CONFERENCE
February 26 & 27, 2009
The Westin La Cantera Resort
San Antonio, Texas

LEE H. SHIDLOFSKY
VISSER SHIDLOFSKY LLP
lee@vsfirm.com

Lee Shidlofsky is a founding partner of Visser Shidlofsky LLP where he heads up the Insurance Law Practice Group. The Insurance Law Practice represents corporate policyholders that are in disputes or litigation with their insurance companies, provides advice to plaintiffs in complex litigation on how to best maximize an insurance recovery, and provides risk-management consultation in connection with contractual risk transfer issues. The Insurance Law Practice Group has handled a wide variety of first-party and third-party insurance claims (e.g., D&O, E&O, "personal and advertising injury liability," construction defect, commercial property, business interruption, pollution, and commercial auto) in state and federal courts at both the trial and appellate courts.

Lee is Secretary of the Insurance Law Section and holds a council position with the Construction Law Section of the State Bar of Texas. He is the author of numerous articles and seminar papers and is a frequent speaker at insurance law and risk management seminars in Texas and across the country.

He has been named a "Super Lawyer" by Texas Monthly Magazine since 2004, including a ranking as a Top 50 attorney in the Central and West Texas Region for 2007 and 2008, and is ranked as a top insurance coverage lawyer by Chambers USA and Who's Who Legal. In addition, Lee was recently elected a Fellow of the Texas Bar Foundation.

Lee graduated *cum laude* from Southern Methodist University School of Law and was an assistant editor on SMU LAW REVIEW.

Notable Cases:

Lamar Homes, Inc. v. Mid-Continent Cas. Co., 242 S.W.3d 1 (Tex. 2007) (answering certified questions in favor of policyholder on "property damage, and "occurrence" issues as well as the "prompt payment of claims" act)

Archon Investments, Inc. v. Great American Ins. Co., 174 S.W.3d 334 (Tex. App.—Houston [1st Dist.] Aug 25, 2005, pet denied.) **(**holding insurer breached the duty to defend against allegations of defective workmanship)

Mt. Hawley Ins. Co. v. Steve Roberts Custom Builders, Inc., 215 F. Supp. 2d 783 (E.D. Tex. 2002) (holding insurer breached duty to defend and, in doing so, violated article 21.55 of the Texas Insurance Code)

For additional information or access to articles and newsletters, please see www.vsfirm.com.

We've Got You Covered

TABLE OF CONTENTS

AN UPDATE ON RECENT INSURANCE COVERAGE DECISIONS AND THEIR IMPACT ON THE CONSTRUCTION INDUSTRY: *THE POLICYHOLDERS' PERSPECTIVE*

I. *Evanston Insurance Co. v. ATOFINA Petrochemicals, Inc.*, 256 S.W.3d 660 (Tex. 2008)

On June 13, 2008, on rehearing, the Supreme Court of Texas handed down another significant insurance decision in *Evanston Insurance Co. v. ATOFINA Petrochemicals, Inc.*, 256 S.W.3d 660 (Tex. 2008). Among other things, the Court's opinion addressed the relationship between an "additional insured" provision and a "contractual indemnity" provision in a subcontract. Moreover, the Court tackled an insurer's ability to contest the reasonableness of a settlement offer once it wrongfully denies coverage for a claim. And, in doing so, the Court significantly retreated from its prior landmark decision in *State Farm Fire & Casualty Co. v. Gandy*, 925 S.W.2d 696 (Tex. 1996). Finally, following on the heels of *Lamar Homes v. Mid-Continent Casualty Company*, the Court made clear that—in the context of liability policies—Article 21.55 of the Texas Insurance Code applies only to the duty to defend and *does not* apply to a breach of the duty to indemnify.

A. Background Facts

ATOFINA Petrochemicals, Inc. ("ATOFINA") entered into a contract with Triple S Industrial Corporation ("Triple S"), wherein the latter agreed to perform maintenance and construction work at ATOFINA's Port Arthur refinery. Under the terms of the contract, Triple S agreed to indemnify ATOFINA for all personal injuries and property losses sustained during the course of the contract, "except to the extend that any such loss is attributable to the concurrent or sole negligence, misconduct, or strict liability of [ATOFINA]." *ATOFINA*, 256 S.W.3d at 662. In addition, Triple S agreed to carry primary and excess CGL insurance, naming ATOFINA as an additional insured on each policy. In complying with that requirement, Triple S procured a primary policy in the amount of $1 million from Admiral Insurance Company ("Admiral") and an excess policy in the amount of $9 million from Evanston Insurance Company ("Evanston").

While performing the contract, Matthew Todd Jones ("Jones"), a Triple S employee, died when he drowned in a storage tank of fuel oil after falling through a corroded roof at the ATOFINA refinery. Jones' survivors sued both Triple S and ATOFINA, alleging claims of wrongful death. Admiral tendered its $1 million limits, and ATOFINA then sought additional insured coverage from Evanston under the umbrella policy. When Evanston denied coverage for the claim, ATOFINA brought the insurer into the lawsuit as a third-party, seeking a declaration that it owed ATOFINA coverage. ATOFINA later severed its lawsuit against Evanston, and both parties moved for partial summary judgment. While those motions were pending, the underlying lawsuit settled for $6.75 million, and ATOFINA sought recovery of $5.75 million from Evanston, which represented the amount remaining after Admiral paid its limits.

At the trial court level, summary judgment was granted in favor of Evanston. The court of appeals reversed, finding that ATOFINA was an additional insured under the Evanston policy and remanding the case to the trial court for determination of statutory penalties and attorneys' fees. *See ATOFINA*

Petrochemicals, Inc. v. Evanston Ins. Co., 104 S.W.3d 247, 251–52 (Tex. App.—Beaumont 2003, pet. granted) (per curiam). On appeal to the Supreme Court of Texas, Evanston argued the following points: (1) ATOFINA is not covered for losses resulting from its sole negligence; (2) ATOFINA is barred under Texas law from obtaining a judgment for insurance proceeds based on losses arising from its own negligence; and (3) the settlement amount was unreasonable and thus unenforceable.

B. Additional Insured v. Contractual Indemnity

At the outset, the Court addressed the distinction between ATOFINA as a contractual indemnitee under the contract with Triple S and its status as an additional insured under the Evanston policy. The Court acknowledged that ATOFINA was not entitled to be indemnified under the parties' contract if the Jones' loss was attributable in any way to ATOFINA. Nevertheless, the Court said: "But ATOFINA does not seek indemnity from Triple S; it claims instead that it is entitled to indemnification from Evanston by virtue of its status as an additional insured on the umbrella policy." *ATOFINA*, 256 S.W.3d at 663–64. Thus, the Court refused to look at the indemnity agreement in the subcontract and looked instead at the terms of the insurance policy itself.

Under the terms of the policy, which included several independent grants of additional insured status, an insured included:

> A person or organization for whom you have agreed to provide insurance as is afforded by this policy; but that person or organization is an insured only with respect to operations performed by you or on your behalf, or facilities owned or used by you.

Id. at 664. Evanston argued that ATOFINA did not qualify as an additional insured because the language does not cover additional insureds for their own negligence. Despite the lack of an apportionment of responsibility in the underlying lawsuit, Evanston urged that because Jones' death was caused solely by ATOFINA's negligence, the death did not "respect . . . operations performed by [Triple S]." *Id.*

The Court recognized a split of authority in the Texas courts of appeals regarding interpretation of additional insured provisions. In *Granite Constr. Co. v. Bituminous Insurance Cos.*, 832 S.W.2d 427, 428 (Tex. App.—Amarillo 1992, no pet.), the court adopted a fault-based interpretation of "arising out of operations" and found that claim before it did not "aris[e] out of operations performed by" the insured because only the additional insured company was responsible for the injury. *ATOFINA*, 256 S.W.3d at 665. Two other courts, on the other hand, adopted a more liberal causation theory of additional insured provisions, finding that such provisions create coverage only "with respect to liability arising out of" the named insured's operations. In *Admiral Insurance Co. v. Trident NGL, Inc.*, 988 S.W.2d 451 (Tex. App.—Houston [1st Dist.] 1999, pet. denied), the court found that because the accident caused injury to an insured's employee while he was on the premises for the purposes of working on a compressor that exploded, the alleged liability for his injuries "arose out of [the insured's] operations" and was covered under the additional insured provision. Similarly, in *McCarthy Brothers Co. v. Continental Lloyds Insurance Co.*, 7 S.W.3d 725, (Tex. App.—Austin 1999, no pet.), the court held that a worker's injury that occurred when

retrieving tools at the job site "arose out of" the insured's operation, even though the negligence claim was against the additional insured premises owner.

Having reviewed that case law, the Court in *ATOFINA* sided with the Houston and Austin courts of appeals because the court in *Granite* relied upon extrinsic evidence when it looked to the terms of the service contract, which made the additional insured company responsible for the specific injury-causing act. *ATOFINA*, 256 S.W.3d at 665. And, the Court said, even if it considered the contract before it in this case, it was distinguishable from that in *Granite*. In particular, the responsibility for maintaining the storage tank at the refinery was not assigned to any particular party in the service contract. The Court said: "Far from shifting any responsibility to ATOFINA, the specific terms of the service contract make Triple S responsible for all operations." *Id.* at 665–66. In addition, regardless of the terms of the underlying contract, the Court held that the "fault-based" interpretation of the additional insured provision is no longer prevailing law. *Id.* at 666. Rather, a more liberal interpretation applies:

> Generally, an event "respects" operations if there exists "a causal connection or relation" between the event and the operations; we do not require proximate cause or legal causation. In cases in which the premises condition caused a personal injury, the injury respects an operation if the operation brings the person to the premises for purposes of that operation. The particular attribution of fault between insured and additional insured does not change the outcome.

Id. (citations omitted). Under that interpretation, the Evanston insurance policy provided direct coverage to ATOFINA. In particular, since Jones was present at ATOFINA's facility for purposes of Triple S's operations when the accident occurred, the requisite causal nexus had been satisfied. *Id.* at 667.

Turning to the scope of coverage afforded under the policy, the Court recognized that several different grants of coverage existed in the "who is an insured" section. The Court found that each granted coverage independently of the others, and that limitations on coverage in one section could not be read into another section granting coverage. Finding that ATOFINA may be entitled to coverage under more than one clause, the Court held that "it is not unreasonable to conclude that the policy should be read to provide the broader measure of coverage available under the applicable clauses." *Id.* at 668–69. Accordingly, the Court determined that the scope of coverage did not exclude liabilities arising out of ATOFINA's sole negligence. *Id.* at 669.

In addition, the Court found Evanston's argument under *Fireman's Fund v. Commercial Standard Insurance Co.*, 490 S.W.2d 818 (Tex. 1972), to be misplaced. In that case, the Court explained, General Motors ("GM") was not entitled to indemnification because the contract at issue did not specifically extend the indemnity agreement to GM's own negligence. Notably, that case did not address the issue as to whether GM was entitled to coverage as an additional insured. Accordingly, the case clearly was distinguishable from the facts at hand. *ATOFINA*, 256 S.W.3d at 669–70. Instead, the Court found that its decision in *Getty Oil Co. v. Insurance Co. of North America*, 845 S.W.2d 794 (Tex. 1992), was more on-point. In that case, the

Court ruled that an insurance requirement in a contract was separate and distinct from an indemnity provision, such that the Anti-Indemnity Statute—which prohibited indemnification for one's own negligence—was inapplicable. Looking at the facts before it, the Court said: "[I]t is unmistakable that the agreement in this case to extend *direct* insured status to ATOFINA as an additional insured is separate and independent from ATOFINA's agreement to forego *contractual* indemnity for its own negligence." *ATOFINA*, 256 S.W.3d at 670. Thus, the *Fireman's Fund* decision did not bar ATOFINA from receiving insurance proceeds for losses arising out of its own negligence. *Id.*

C. A Breaching Insurer Cannot Question the Reasonableness of a Settlement

Having determined that ATOFINA was covered under Evanston's insurance policy, the Court next addressed Evanston's argument that ATOFINA failed to prove the reasonableness of the $6.75 million settlement. In particular, Evanston argued that it was not "bound" by the settlement. ATOFINA, in contrast, argued that Evanston's denial of coverage bars it from challenging the reasonableness of the settlement.

The Court turned to its prior decision in *Employers Casualty Co. v. Block*, 744 S.W.2d 940 (Tex. 1988), in which it held that an insurer that wrongfully denies coverage is barred from challenging the reasonableness of the settlement amount agreed to by an insured in an agreed judgment. The Court acknowledged that differences existed between the case before it and the facts in *Block*, but found that the rule applied nonetheless. In *Block*, the Court addressed two questions regarding the effect of an agreed judgment between the plaintiffs and the insured: (1) did the agreed judgment bar the insurer from contesting the reasonableness of the settlement; and (2) did the same agreed judgment bar the insurer from contesting the agreed judgment's factual recitations regarding coverage?

Block's answer was clear:

> While *we agree with the court of appeals' conclusion that [the insurer] was barred from collaterally attacking the agreed judgment by litigating the reasonableness of the damages recited therein*, we do not agree with its conclusion that the recitation in the agreed judgment that the damage resulted from an occurrence on August 6, 1980 is binding and conclusive against [the insurer] in the present suit.

ATOFINA, 256 S.W.3d at 671 (quoting *Block*, 744 S.W.2d at 943).

The Court explained that in *Block* the insurer had violated the duty to defend, but in the case before it, Evanston had denied coverage altogether and no duty to defend was implicated. Additionally, the *Block* case was settled by agreed judgment, while ATOFINA employed a contractual settlement agreement and non-suit. Nevertheless, the Court held that those differences did not render *Block* inapplicable because the basis of the opinion did not rest upon the nature of the violated policy term or the formality of agreed judgments. Rather, those cases that bar an insurer's challenge "rest on principles of waiver and estoppel." Quite simply, "the principles of notice to the insurer and an intentional choice to forego *participation* in settlement discussions operate the same no matter how the insurer chooses to attack the settlement. . . . Had Evanston not

unconditionally denied coverage, it too would have been able to influence the amount of the settlement." *Id.* at 672.

The Court then addressed the differences in posture of the *Block* case vis-à-vis the facts of the case before it. In *Block*, the underlying plaintiff sued the insurer as a judgment creditor, which drew criticism from the Court in *State Farm Fire & Casualty Co. v. Gandy*, 925 S.W.2d 696 (Tex. 1996). There the Court said:

> In no event, however, 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. We disapprove the contrary suggestion in dicta in *Employers Casualty Co. v. Block*, 744 S.W.2d 940, 943 (Tex. 1988), and *United States Aviation Underwriters, Inc. v. Olympia Wings, Inc.*, 896 F.2d 949, 954 (5th Cir. 1990).

ATOFINA, 256 S.W.3d at 673 (quoting *Gandy*, 925 S.W.2d at 714). The Court then said that *Gandy* did not prevent the application of *Block* to the instant case for two reasons: (1) the case did not fit within *Gandy's* "explicit and narrow" holding that only applied to a "specific set of assignments with special attributes"; and (2) the case did not implicate the concerns in *Gandy* with respect to muddying the waters as to evaluation of the merits of a plaintiff's claim with prolonged disputes and distorted trial litigation motives. *Id.* Expanding on that, the Court held that in the case before it, the "key factual predicate" of *Gandy* was missing because ATOFINA did not assign its claim against Evanston, but filed suit directly, which "removes this case from the formal bounds of *Gandy*." *Id.* In addition, preventing Evanston from challenging the reasonableness of the settlement would not extend the dispute, but would, by definition, shorten it. *Id.* at 674. Moreover, because ATOFINA was unsure if it would be covered, it never lost its motive to minimize the settlement amount, as it was unclear who ultimately would be responsible for footing the bill. Accordingly, to accomplish *Gandy's* goal regarding the fair determination of the value of a plaintiff's claim, the Court applied the *Block* rule, which encourages early intervention by insurers who are best suited for evaluating the value of a claim during settlement discussions. As such, the Court held that Evanston was barred from disputing the reasonableness of ATOFINA's settlement in light of Evanston's denial of coverage. Thus, Evanston was bound to pay the remaining $5.75 million of the settlement. The Court, however, was careful to note that while a collateral attack on the reasonableness of a settlement is impermissible, an insurer remains free to challenge coverage. *Id.* at 674 n.74.

D. Article 21.55 Applies only to the Duty to Defend

In *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 242 S.W.3d 1 (Tex. 2007), the Supreme Court of Texas held that Article 21.55 (now re-codified at TEX. INS. CODE §§ 542.051–.061) applies to a CGL insurer's breach of the duty to defend. In *Lamar Homes*, the Court suggested that the duty to defend was a first-party duty owed by an insurer to the insured. *Id.* In *ATOFINA*, the Court rejected any application of Article 21.55 to a breach of the duty to indemnify. "A loss incurred in satisfaction of a settlement belongs to the third party and is not suffered directly by the insured." *ATOFINA*, 256 S.W.3d at 674.

Commentary:

The ruling in *ATOFINA* is extremely significant. First, the Court made clear that a distinction exists between an indemnity provision and an additional insured requirement under a contract. Accordingly, at least in most circumstances, the limitations of one are not applicable to the other. Second, the Court read the multiple additional insured grants independent of one another and refused to apply limitations in one to another. This indicates the importance of reading the additional insured or "Who is an Insured" language very carefully. Third, and perhaps most importantly, the Court reigned in its earlier decision in *Gandy*. For over a decade, insureds and insurers alike have read the broad-sweeping language of *Gandy* to mean that its principles applied beyond the facts of the case at the Court's fingertips. In *ATOFINA*, the Court, in language that hardly can be considered dicta, specifically held that *Gandy* only applied in a limited set of circumstances. For example, it appears that *Gandy* becomes an issue only in cases where a pre-trial assignment of an insured's claim against its insurer has been made. Accordingly, even though there was no "fully adversarial trial," Evanston could not contest the reasonableness of ATOFINA's $6.75 million settlement. Fourth, the Court clarified that Article 21.55 does not apply to the duty to indemnify.

II. *Unauthorized Practice of Law Committee v. American Home Assurance Co.*, 261 S.W.3d 24 (Tex. 2008)

A constant question across the country and in Texas is the legality of insurers' use of salaried staff attorneys to represent an insured when its interests are not necessarily in line with the client's. Or, in other words, as the Supreme Court of Texas framed the question in *Unauthorized Practice of Law Committee v. American Home Assurance Co.*, 261 S.W.3d 24 (Tex. 2008): "The issue in this case is whether a liability insurer that uses staff attorneys to defend claims against its insureds is representing its own interests, which is permitted, or engaging in the unauthorized practice of law, which is not." *Id.* at 26. In a 7-2 opinion, authored by Justice Nathan Hecht, the Supreme Court of Texas held that an insurer may use staff attorneys so long as the insured's and the insurer's interests are aligned—that is, the two are aligned in defeating the claim and no conflict of interest exists. *Id.* at 26–27. In addition, the Court held that a staff attorney is obligated to inform the insured of its affiliation with the insurer. *Id.* at 27. The opinion, however, has implications that potentially reach far beyond the narrow issue of the use of staff attorneys.

A. Shaping the Issue

Liability insurers often include provisions in their policies that require them to defend their insureds, but give them "complete and exclusive control" of that defense. *Id.* In doing so, insurers utilize three "types" of attorneys: (1) private law firms, whose work is paid for and overseen by the insurer; (2) "captive" law firms, whose lawyers are not employees of the insurer, but who have no other clients; and (3) in-house, salaried corporate staff attorneys. *Id.* Regardless of the "type" of attorney hired, according to the Court at least, the obligations remain the same: an insurer must provide the insured with the same, unqualified loyalty that it would have if the insured had hired him or her directly and protect the interests of the insured if the insurer's instructions would otherwise compromise them. *Id.* (citing *Employers Cas. Co. v. Tilley*, 496 S.W.2d 552, 558 (Tex. 1973); *State Farm Mut. Auto. Ins. Co. v. Traver*, 980 S.W.2d 625, 627 (Tex. 1998)). Arguments for and against the

use of staff attorneys are abundant. Insurers claim that they are more efficient, which lowers costs and—more importantly—premiums. And, according to insurers, such attorneys are useful as an "advertising tool" in selling policies. *Id.* at 27–28. Opponents, on the other hand, claim that if an insurer controls its staff attorneys as an employer would control any employee, then the attorney-client relationship is detrimentally impaired from the insured's standpoint. *Id.* at 28.

The use of staff attorneys began in the late 19th century and is widespread. Historically, both the American Bar Association Committee on Ethics and Professional Responsibility (in 1950 and 2003) and the State Bar of Texas Committee on Interpretation of the Canons of Ethics (in 1963) have found that such conduct was ethical. Amicus curiae in support of the use of staff counsel noted that 15 insurers in 39 offices employ 220 attorneys in Texas, and those attorneys currently defend insureds in over 10,000 cases in the state. *Id.* at 28–29.

In Texas, to practice law, one must be licensed by the Supreme Court or have special permission. And, once admitted to practice in the state, attorneys are required to attend continuing education classes and be subject—as necessary—to a grievance process. Finally, the Unauthorized Practice of Law Committee (the "Committee") investigates and prosecutes the unauthorized practice of the profession. *Id.* at 29–30.

B. Background Facts

In 1998, the Committee sued Allstate Insurance Company ("Allstate"), alleging that Allstate's use of staff attorneys to defend liability claims violated Texas law regarding the unauthorized practice of law. *Id.* at 30 (citing *UPLC v. Collins*, No. 98-8269 (298th Dist. Ct., Dallas County, Tex. 1998).) Thereafter, Nationwide filed a declaratory judgment action against the Committee that Texas law did not prohibit the use of staff attorneys and that, if it did, such law was in violation of the U.S. Constitution. *Id.* (citing *Nationwide Mut. Ins. Co. v. UPLC*, 283 F.3d 650, 651 (5th Cir. 2002)). The district court in that case abstained under the *Pullman* doctrine and dismissed the case with prejudice, which the Fifth Circuit affirmed in substance but reversed the dismissal with prejudice and remanded the case for dismissal without prejudice. *Id.* (citing *Nationwide*, 283 F.3d at 657). In that case, the Fifth Circuit analyzed Texas law and held:

> [W]e believe that the law is fairly susceptible to a reading that would permit Nationwide to employ staff counsel on behalf of its insureds While the Texas courts certainly may decide that Nationwide's staff attorneys are engaged in the unauthorized practice of law, we believe that the law is uncertain enough on this issue that we should abstain from ruling on its federal constitutionality.

Id. (quoting *Nationwide*, 283 F.3d at 655).

As a result, Nationwide re-filed its lawsuit in state court, received a favorable ruling that was affirmed on appeal, and which the Committee petitioned the Court to review while the instant case was pending. The instant case arose out of a letter from the Committee to Katherine D. Woodruff, a staff attorney of American Home Assurance Co. ("American Home") at Woodruff & Associates, informing her that she and her firm were being investigated for the unauthorized practice of law. *Id.* at 30–31. American Home, Woodruff & Associates and Travelers Indemnity Co. ("Travelers") brought the instant suit, seeking a

declaration that the use of staff counsel was not the unauthorized practice of law. *Id.* at 31. The Committee filed a counterclaim. Then, all the claims by and against Woodruff and her firm were nonsuited. Eventually, American Home, Travelers and the Committee cross-moved for summary judgment. The insurers' motions were denied and the Committee's granted. *Id.* The court declared that each insurer's "use . . . of staff counsel who are employees . . . to defend insureds (third parties) in Texas is the unauthorized practice of law." *Id.* Judgment was suspended by the court pending appeal, and the parties agreed to the following policy:

> If in the course of representing a party insured by [American Home and Travelers] any staff counsel employed in Texas by [such insurer, respectively] seeks advice about a potential conflict of interest between the insured and the insurance company, or any other question of professional ethics, such staff counsel will first consult with the Texas-licensed lawyer who is head of the staff counsel office, and thereafter, if the staff counsel's concerns are not resolved, counsel with an outside Texas firm, designated by [such insurer, respectively], on such question.

Id. The Eleventh District Court of Appeals in Eastland reversed the lower court, rejecting the Committee's position in its entirety. *Id.* (citing *UPLC v. Am. Home Assurance Co.*, 121 S.W.3d 831, 833, 846 (Tex. App.—Eastland 2003, pet. granted)). In sum, that court found: (1) staff counsel faced no different conflicts than outside counsel; (2) the use of staff counsel does not violate any one of a number of Texas' Disciplinary Rules of Professional Conduct; (3) the Supreme Court's statement that an insurance defense lawyer owes "unqualified loyalty" to an insured was dicta and does not prevent the insurer from being a client, so long as no conflict exists; (4) the use of staff counsel does not violate the Texas Business Corporation Act or the Texas Government Code—if the use of staff counsel is unauthorized, so also is the use of outside counsel; (5) Section 38.123 of the Texas Penal Code should not be read so as to prohibit the use of staff attorneys anymore than it should be read to prohibit insurance defense in general; and (6) only two states—North Carolina and Kentucky—prohibit the use of staff attorneys while several others do not. *Id.* at 31–32 (citing *UPLC v. Am. Home*, 121 S.W.3d at 836–45).

On appeal to the Court, two issues were presented:

> (1) Does the use of staff attorneys to defend liability claims as contractually required constitute the unauthorized practice of law?
>
> (2) If not, must the staff attorneys' affiliation with the insurer be fully disclosed to the insured?

Id. at 32. In looking at these issues, the Court rejected the request by amicus curiae to determine what the practice of law *should be*, and focused instead on what it *is* under current law. *Id.*

C. Corporations Cannot Practice Law and An Insurer with Staff Counsel Is Not Doing So

The parties agreed that a corporation is unable to practice law and that the Supreme Court of Texas has inherent power to

regulate the practice of law. The Court adopts rules governing admission to the practice of law, permitting only individuals meeting particular criteria that opportunity. "Entities, including insurance companies, are excluded." *Id.* at 33.

The Committee, however, relied upon a more general provision of the Texas Business Corporation Act, which prohibits a corporation from transacting business in the state:

> If any one or more of its purposes . . . is to engage in any activity which cannot lawfully be engaged in without first obtaining a license under the authority of the laws of this State . . . and such a license cannot lawfully be granted to a corporation.

Id. at 33 (citing TEX. BUS. CORP. CODE art. 2.01(B)(2)). The appellate court rejected that argument, finding that an insurance company is not organized to practice law. *Id.* at 33–34 (citing *UPLC v. Am. Home*, 121 S.W.3d at 839). The Court disagreed with that finding because the provision applies whenever "any one" of the corporation's purposes is to engage in a licensed activity. The Court also rejected the appellate court's finding that an insurer's defense of its insured is "collateral" to its purpose of indemnifying its insured, as one is no less important than another. *Id.* at 34. The Court said, however, that it need not construe that provision because its rules "governing admission to practice law are sufficient to exclude insurance companies from engaging in *that* activity." *Id.* (emphasis in original).

The Court then acknowledged that the parties were in agreement that an insurance company is not engaging in the practice of law when it uses salaried staff counsel to represent its own interests. *Id.* The Court explained that such practice has long been held acceptable. Insurers can hire in-house counsel to provide advice regarding the legal affairs of the company and can appear in court on that entity's behalf. *Id.* And while the article of the Penal Code the Court relied upon to make that finding had been repealed, the repeal had no bearing on the use of house counsel. *Id.* (explaining that Article 430a of the Texas Penal Code was repealed because the Legislature found that in light of the Court's power to govern the practice of law the article "had no practical value"). The Court also explained that this view is bolstered by the State Bar of Texas Committee on Interpretation of the Canons of Ethics, which has found nothing unacceptable about the use of in-house counsel by a corporation. *Id.* at 35. Quite simply, "a corporation does not engage in practicing law by employing an attorney to represent itself, together with the common interests of other employers and affiliates." *Id.*

Further, when an insurance company hires private counsel to defend its insured, such action does not constitute the practice of law. *Id.* This was true under Article 430a of the Texas Penal Code before its repeal, and remains true under Section 81.101(a) of the Texas Government Code, which defines the practice of law today. Implicit in either is the understanding that the practice of law involves the rendering of legal services *for someone else*. "Only when a corporation employs attorneys to represent the unrelated interests of others does it engage in the practice of law." *Id.* at 36.

Thus, when an insurer uses staff counsel to defend its insureds, is it practicing law or merely defending its interests by discharging its duty to the insureds and fighting claims for which it would be required to indemnify the insured? On that, the Court found that American Home's and Travelers' reliance

upon its decision in *Utilities Insurance Co. v. Montgomery*, 138 S.W.2d 1062 (Tex. 1940), was misplaced because that case involved the obtaining of non-waiver agreements, which are used to protect the insurer's interest and not the insured's. *Id.* (citing *Montgomery*, 138 S.W.2d at 1064, and mistakenly suggesting that unilateral reservation of rights letters are the same thing as bilateral non-waiver agreements). The Court said nothing about the insurer's interest in defending its insureds in that case, and, more importantly, the Court never suggested that the counsel at issue in that case were staff counsel instead of private practice attorneys. *Id.*

More on point, the Court said, was its decision four years later in *Hexter Title & Abstract Co. v. Grievance Committee*, 179 S.W.2d 946 (Tex. 1944). There, the Court found that Hexter was engaged in the unauthorized practice of law. The Court said that its opinions regarding defects of title and instruments that could be used to correct them, which were conveyances in which the insurance company was not a party but rather had a prospective interest in them, affected the rights of individuals apart from Hexter's interest in the title insurance industry. *Id.* at 37 (citing *Hexter*, 179 S.W.2d at 952). In other words, the corporation's purpose was to take applications for insurance and insure title as it was or reject it. If defects existed, then the applicant had to cure them, not the title insurance company. *Id.* Thus, the Court concluded in *Hexter* that the company was engaged in the unauthorized practice of law, but "emphasized that Hexter was permitted to employ salaried attorneys to advise it on the state of title for its own uses; it was prohibited only from providing the same service to customers and prospective customers for their use." *Id.* at 38.

From that decision the Court found three factors to be considered in determining the issue before it:

(1) Is the company's interest being served by the rendition of legal services existing or only prospective?

(2) Does the company have a direct, substantial financial interest in the matter for which it provides legal services?

(3) Is the company's interest aligned with that of the person to whom the company is providing legal services?

Regarding the first factor, the Court found that insurers render legal services to fulfill its contractual obligations to its insured and not to attract business even though the insurer may advertise the use of staff counsel and the resulting lower premiums. As for the second factor, the insurer clearly has a direct, substantial financial interest because if it defeats the claim, then the insurer is benefited by not having to pay the claim. Finally, with respect to the third factor—the most important factor according to the Court—the Court found that "in the vast majority of cases," the interests of an insurer and its insured are aligned against the claim, and such interests differ only when a coverage question exists or the rendering of the legal defense causes consequences that affect them differently. *Id.* Applying those factors, the Court said:

> [W]e conclude that a liability insurer does not engage in the practice of law by providing staff attorneys to defend claims against insureds, provided that the insurer's interests and the insured's interests in the defense in the particular case

> at bar are congruent. In such cases, a staff attorney's representation of the insured and insurer is indistinguishable.

Id. at 39.

Having reached that conclusion, the Court turned to the serious concerns raised by the Committee and several amici about conflicts between an insured and an insurer being exacerbated because of the employment relationship between the insurer and its staff counsel. *Id.* In particular, those parties argued that the pressures and loyalties of that employment relationship jeopardize a staff attorney's ability to exercise independent judgment to which the insured is entitled. Moreover, they argue, "the insurer's profit motive . . . is fundamentally inconsistent with the provision of independent legal services through staff attorneys." *Id.*

The Court noted that the Committee and amici were unable to point to an ounce of empirical evidence of injury to a private or public interest stemming from the representation of an insured by staff counsel. This is important in light of the fact that staff counsel has been used for decades across the nation. *Id.* The Court explained that conflicts that arise may be resolved by staff attorneys just as other attorneys would or—if unable to be resolved—they can withdraw just as other attorneys would. *Id.* at 39–40. Importantly, the Court explained that most often the coverage questions at issue are whether a claim is within the policy limits and the type of coverage provided. The insurer in such instances can issue a reservation of rights letter, and, in fact, insurers seem to do so now merely as a prophylactic measure, even if they have no specific intent to pursue a coverage question. *Id.* at 40. Then, while seemingly brushing aside the importance of reservation of rights letters, the Court said that "[a] reservation-of-rights letter ordinarily does not, by itself, create a conflict between the insured and the insurer" because it only recognizes that a conflict might exist later. *Id.* The Court refused to say that staff counsel can never represent an insured when a "routine" reservation of rights letter is issued. *Id.*

The Court also found that problems may arise when defense counsel acquires information that the insured would expect to be kept confidential and not disclosed to the insurer. It explained, though, that in such situations withdrawal by the attorney may be the best option regardless of whether the attorney is staff counsel or in private practice. *Id.* Under Texas' law, which imputes knowledge of confidential information held by one attorney to all of the attorneys in his office, a staff attorney's knowledge of such information may or may not be imputed to non-attorneys outside the legal department. The Court said that such knowledge could estop an insurer from using it altogether. But, while these risks are present, "they do not necessarily destroy the congruence of the insurer's and insured's interest." *Id.* at 41. The Court also failed to find that a staff attorney's obligation of unqualified loyalty in a *Stowers* situation is any different from that of an attorney in private practice. While it is possible that counsel may fail to render the loyalty required because of business pressure, no evidence exists that a staff attorney is more likely to fail in that regard. *Id.* The Court also failed to find that a staff attorney is more likely to adhere to its employer's restrictions found in litigation guidelines even when it could compromise an insured's interests. *Id.*

The Court seemingly answered a long-standing debate in Texas as to whether Texas is a one-client or two-client state. *Id.*

at 42. In particular, the Committee claimed that Texas law only allows defense counsel to represent the insured and that staff attorneys violate that rule because they necessarily represent the insurer and thus cannot represent the insured as well. In response, the Court said: "But we have never held that an insurance defense lawyer *cannot* represent both the insurer and the insured, only that the lawyer *must* represent the insured and protect his interests from compromise by the insurer." *Id.* Accordingly, at least where a congruence of interest exists, the Court suggests that Texas is a two-client state.

In sum, the Court looked at the concerns of the Committee and of amici, but found that those concerns should not be avoided at all cost when some are satisfactorily resolved. The Court acknowledged that the use of staff counsel "comes with risks." *Id.* Accordingly, the Court held:

> If an insurer's interest conflicts with an insured's, or the insurer acquires confidential information that it cannot be permitted to use against the insured, or an insurer attempts to compromise a staff attorney's independent, professional judgment, or in some other way the insurer's and insured's interests do not have the congruence they have in the many cases in which they are united in simple opposition to the claim, then the insurer cannot use a staff attorney to defend the claim without engaging in the practice of law. But there are a great many cases that can be defended by staff attorneys without conflict and to the benefit of mutual interests. The use of staff attorneys in those cases does not constitute the unauthorized practice of law.

Id. at 42–43.

In its final comments, the Court rejected the Committee's argument that section 38.123 of the Texas Penal Code prohibits the use of staff counsel. *Id.* at 44. The Court found that that section could not apply to liability insurers' defense of their insureds because part of the section would make every insurer a felon. That is, the section at issue "prohibits any contract that grants one party the exclusive right to select and retain legal counsel to represent the other." *Id.* at 45. Considering insurers have done that for years, reading the section to apply in the situation at bar was "too much to believe." *Id.*

In conclusion, the Court said that insurers could use staff attorneys to defend claims against their insureds so long as their interests were congruent as described in the opinion. In addition, such attorneys are required to disclose their relationship with the insurer to the insured. *Id.*

D. The Dissent

A lengthy dissent was authored by Justice Johnson, and it was joined by Justice Green. In sum, those Justices argued that there is understandably nothing wrong with an insurer representing its own interests in a lawsuit if it so chooses. The concern, however, is that an insurer simply cannot represent a client (i.e., its insured) under the State Bar Act. The dissenters contend that the acts of staff attorneys are imputed to their employer, the insurer. Accordingly, they argue that when staff attorneys represent an insured, the *insurer* is representing the insured in violation of the Act because it is practicing law without a license. Based on that logic, Justices Johnson and Green would have reversed the appellate court's decision.

Commentary:

The Court's holding regarding the use of staff counsel not being the unauthorized practice of law comports with the findings of most states across the country. Accordingly, the Court's opinion is somewhat unremarkable in that sense. What is surprising, however, is the Court's discussion of reservation of rights letter in which it said that such letters oftentimes do not create a conflict of interest between the insurer and the insured. The Court explained that such letters are becoming "routine" and used more often for prophylactic measures. While it is true that not every reservation of rights letter creates a conflict of interest, the Court's somewhat nonchalant treatment of reservation of rights letters raises an interesting question as to the viability of other decisions wherein reservation or rights letters were found to create a conflict of interest so as to afford the insured with the right to select independent counsel. Notably, after *UPLC*, it may be more difficult to argue that a reservation of rights entitles an insured to independent counsel. Stated otherwise, while the Court recognized the long-standing rule that any "type" of attorney owes unqualified loyalty to the insured, the opinion begs the question of when a sufficient conflict exists so as to give an insured the right to select independent counsel.

Notably, a motion for rehearing filed by the UPLC was denied on September 26, 2008.

III. *Ulico Casualty Co. v. Allied Pilots Association*, 262 S.W.3d 773 (Tex. 2008)

On August 29, 2008, the Supreme Court of Texas issued an opinion in *Ulico Casualty Co. v. Allied Pilots Association*, 262 S.W.3d 773 (Tex. 2008), in which it addressed the doctrines of waiver and estoppel. In particular, the Court considered "whether an insurer's contractual coverage under a claims-made policy can be expanded by the doctrines of waiver and estoppel to cover a risk not otherwise within the policy coverage." *Id.* at 775. In a lengthy (and confusing) opinion, the Court held that if an insurer prejudices its insured by its actions, it "may be estopped from denying benefits that would be payable under its policy as if the risk had been covered, but the doctrines of waiver and estoppel cannot be used to re-write the contract of insurance and provide contractual coverage for risks not insured." *Id.*

A. Background Facts

Allied Pilots Association ("APA") was insured under a claims-made liability policy issued by Ulico Casualty Company ("Ulico"). The policy was effective from August 25, 1998 to August 25, 1999, and provided the following pertinent coverage:

> [A]ll Loss which such Insured shall become legally obligated to pay on account of any claim made against the Insured during the Policy Period or, if exercised, during the Extended Reporting Period, for a Wrongful Act committed, attempted, or allegedly committed or attempted by such Insured before or during the Policy Period, and reported to [Ulico] . . . during the Policy Period or the Extended Reporting Period, if elected.

Id. By definition, "loss" included defense costs. *Id.* As a condition precedent to coverage, APA was to "give to [Ulico] written notice during the Policy Period or the Extended Reporting Period, if elected, of any claim made against [APA] for a Wrongful Act." *Id.* If the policy was cancelled or non-renewed by Ulico, APA

could obtain an additional twelve months beyond the policy expiration in which to report claims made against it based on acts committed by it during the policy period. To get this Extended Reporting Period ("ERP"), APA had to pay an additional premium in the amount of fifty percent of the annual premium. *Id.* Further, if APA terminated the policy or chose not to renew, Ulico could, "[i]f requested, at its sole discretion, grant an [ERP]." *Id.*

By two separate endorsements, and after receiving additional premiums from APA, Ulico extended the policy period first from August 25, 1999 to September 25, 1999, and then again to October 25, 1999. *Id.* at 776. On October 4, 1999, APA was served with a lawsuit styled as *Allen v. American Airlines, Inc.*, (the "Underlying Lawsuit"), which it forwarded to its insurance broker and its regular outside counsel, James & Hoffman, which undertook APA's defense. *Id.* Ulico, however, was not notified of the lawsuit until APA's agent forwarded notice to it on November 5, 1999. At the time that Ulico received notice, APA was insured under a new policy issued by Lexington Insurance Company. *Id.* at 776 n.1.

In December 1999, Ulico informed APA that its claim was being reviewed and that it would be notified at a later date of Ulico's coverage decision. APA was informed that pursuant to the policy's terms, no defense fees, costs, charges, or expenses could be incurred or settlements made without prior consent from Ulico. *Id.* Then, in March 2000, Ulico told APA that its policy provided for defense costs, but that it was expressly reserving all of its rights to deny coverage. Enclosed with the March 2000 letter were litigation management forms, attorney evaluation forms, and a form for the attorney's time forecast. APA's counsel did not respond to the letter. In April 2001, and in reference to its March 2000 letter, Ulico told APA that "Ulico has agreed to reimburse [APA] for reasonable and necessary defense expenses." *Id.* A month later, James & Hoffman forwarded to Ulico its billings of approximately $635,000 for the defense of APA in the Underlying Lawsuit. *Id.* Neither APA nor James & Hoffman sought Ulico's approval for any actions taken in the Underlying Lawsuit or for authorization to incur expenses in APA's defense. In September 2001, summary judgment was granted in APA's favor and the plaintiffs' appeal was dismissed. *Id.*

In November 2001, Ulico filed a declaratory judgment action, seeking a declaration that it did not have coverage for the Underlying Lawsuit and did not owe APA's defense costs. *Id.* at 777. At trial, the jury found that (1) Ulico granted an ERP during which APA reported the Underlying Lawsuit; (2) Ulico agreed to pay defense costs separate and apart from the policy; (3) Ulico waived its right to assert that the policy did not cover the defense costs; and (4) Ulico was estopped from asserting that the defense costs were not covered. On cross-motions for judgment notwithstanding the verdict, the trial judge set aside the jury findings that Ulico granted an ERP, that Ulico agreed to pay defense costs separately from the policy, and of damages. It entered judgment in favor of APA on the waiver and estoppel findings in the amount of $616,468.55. *Id.*

On appeal, the Fort Worth Court of Appeals relied upon what is known as the *Wilkinson* exception, affirming the lower court on the basis of waiver and estoppel. *Id.* (citing *Farmers Texas County Mutual Insurance Co. v. Wilkinson*, 601 S.W.2d 520 (Tex. Civ. App.—Austin 1980, writ ref'd n.r.e.)); *see also Ulico Cas. Co. v. Allied Pilots Ass'n*, 187 S.W.3d 91 (Tex. App.—Fort Worth 2005, pet. granted). Further, that court found that the recovery was under the contract of insurance, so it awarded

attorneys' fees under Chapter 38 of the Civil Practice and Remedies Code. *Ulico*, 262 S.W.3d at 776–77 (citing *Ulico Cas. Co. v. Allied Pilots Ass'n*, 187 S.W.3d at 108–10). The case then was remanded for determination of the amount of attorneys' fees to be awarded. *Id.* at 777 (citing *Ulico Cas. Co. v. Allied Pilots Ass'n*, 187 S.W.3d at 110).

On petition for review to the Supreme Court, Ulico claimed that the court of appeals erred in its reliance upon the doctrines of waiver and estoppel. APA, on the other hand, urged that the trial court erred in dismissing the jury's findings that Ulico granted an ERP to APA during which APA provided written notice of the Underlying Lawsuit., and that Ulico agreed to pay defense costs for that lawsuit separate from the insurance policy. The court of appeals did not reach those issues, as its findings regarding waiver and estoppel were dispositive. *Id.* The Supreme Court also did not reach the issues as it held that Ulico's coverage was not expanded by either waiver or estoppel so as to bring within coverage the claims made in the Underlying Lawsuit. It also upheld the trial court's decision to disregard the jury's finding as to the ERP and Ulico's separate agreement to cover APA's defense costs. *Id.*

B. Waiver and Estoppel

As insurance policies are contracts, courts construe them under the same rules that apply to contracts in general. The burden is on the insured to assert a covered loss, and then the burden shifts to the insurer to assert any applicable exclusion or limitation to avoid liability. *Id.* at 778. Importantly, though, when a policy only covers risks for a certain time period, "the time of the event allegedly triggering coverage is a precondition to coverage and is not considered a defensive matter to be pleaded and proved by the insurer." *Id.*

As for the doctrines of waiver and estoppel, they often are referenced together although they are quite different. Waiver requires an intentional relinquishment of a known right. Estoppel, on the other hand, requires false representation or concealment of material facts by an insurer upon which an insured relies detrimentally without knowledge or means of obtaining knowledge of those facts. *Id.*

Addressing whether the doctrines of waiver and estoppel can rewrite the insurance policy, the Court relied upon its decision in *Washington National Insurance Co. v. Craddock*, 109 S.W.2d 165 (Tex. 1937). In that case, the Court found that an insurer's act of paying weekly benefits for a non-covered injury did not waive the insurer's right to rely on a gunshot wound exclusion or estop the carrier from denying its liability by virtue of the waiver. *Id.* at 166. There, the Court said:

> The question presented is not whether the act of the insurance company in making payments would constitute a waiver of its right to forfeit the policy on account of some breach by the insured of its terms, but is whether a contractual liability may be created by a waiver. By its policy the insurance company did not assume any liability for the risk declared upon and no consideration moved to it after the accident for the assumption of such liability. The insured seeks to create that liability by invoking the doctrine of waiver. The doctrine cannot be made to serve that purpose.

Id. at 166 (citation omitted). After citing a number of out-of-state cases containing similar language, the *Craddock* court "held that the doctrines of waiver and estoppel

could not create a contract covering a risk not assumed by the insurer." *Ulico*, 262 S.W.3d at 779 (citing *Craddock*, 109 S.W.2d at 167).

In *Ulico*, the Court then addressed its 1988 decision in *Texas Farmers Insurance Co. v. McGuire*, 744 S.W.2d 601 (Tex. 1988), in which McGuire sought to invoke the doctrine of estoppel to create coverage because Farmers did not advise him to hire his own attorney before he gave a second statement to the insurer. *Ulico*, 262 S.W.3d at 779–80. While the court of appeals rendered judgment in favor of McGuire based on *Employers Casualty Co. v. Tilley*, 496 S.W.2d 552 (Tex. 1973), the Court, on appeal, rejected that argument, finding again that "[t]he doctrine of estoppel cannot be used to create insurance coverage where none exists by the terms of the policy." *Ulico*, 262 S.W.3d at 780 (citing *McGuire*, 744 S.W.2d at 602). Further, the Court said in *McGuire*:

> Waiver and estoppel may operate to avoid a forfeiture of a policy, but they have consistently been denied operative force to change, re-write and enlarge the risks covered by a policy. *In other words, waiver and estoppel cannot create a new and different contract with respect to risks covered by the policy. Great Am. Reserve Ins. Co. v. Mitchell*, 335 S.W.2d 707 (Tex.Civ.App.-San Antonio 1960, writ ref'd).
>
> In *Tilley* the insurer was estopped by the actions of its attorney from asserting that the insured had forfeited policy coverage because of late notice. *The case at hand does not involve a forfeiture; instead, it involves a question of risk coverage under the contract. Because Texas Farmers' action cannot estop it from relying on the limitations of risk coverage set forth in the contract, it is not responsible for the judgment against McGuire.*

Id. at 780 (quoting *McGuire*, 744 S.W.2d at 602–03) (emphasis added). In that case, although the Court mentioned the *Wilkinson* exception, it did not discuss it. In *Ulico*, however, the Court took the opportunity to address the exception in full.

In *Wilkinson*, Texas Farmers County Mutual insured a Datsun owned by Berta Wilkinson's son, Clifton. *Id.* (citing *Wilkinson*, 601 S.W.2d at 521). Clifton sold the Datsun and replaced it with a Ford, which he later was driving when involved in an accident. *Id.* Farmers, without raising a question as to coverage, paid for the property damage for the other vehicle and then attempted to settle the personal injury claims, but negotiations failed. The third party ultimately sued Clifton and, in the meantime, Farmers continued to try to settle the case without raising an issue as to coverage. Four-and-a-half years later, Farmers sought a declaration that it did not owe coverage because Clifton was not a named insured and the Ford was not an insured vehicle. *Id.* Thereafter, Farmers sent two letters: (1) Farmers told Clifton it had forwarded the lawsuit to attorneys to defend Clifton; and (2) Farmers reserved its rights to assert that there was no coverage under the policy. By jury verdict, the trial court entered judgment that Farmers' policy covered Clifton and that a duty to defend him in the liability lawsuit existed. *Id.* at 780–81.

On appeal, the appellate court affirmed, noting "the 'well-established' rule that 'the doctrines of waiver and estoppel may operate to avoid conditions that would cause a forfeiture of an insurance policy, [but] they

will not operate to change, re-write or enlarge the risks covered by the policy.'" *Id.* at 781 (quoting *Wilkinson*, 601 S.W.2d at 521). The *Wilkinson* court then stated, however, that from those general principles it follows that:

> [I]if an insurer assumes the insured's defense without obtaining a reservation of rights or a non-waiver agreement and with knowledge of the facts indicating noncoverage, all policy defenses, including those of noncoverage, are waived, or the insurer may be estopped from raising them. *Pacific Indemnity Co. v. Acel Delivery Service, Inc.*, 485 F.2d 1169 (5th Cir.1973); *Ferris v. Southern Underwriters*, 109 S.W.2d 223 (Tex.Civ.App.-Austin 1937, writ ref'd); *Automobile Underwriters' Ins. Co. v. Murrah*, 40 S.W.2d 233 (Tex.Civ.App.-Dallas 1931, writ ref'd). See: 81 A.L.R. 1326 (1932); 38 A.L.R.2d 1148 (1954); 7C Appleman, Insurance Law & Practices 4892 (1979). This rule is based on the "[] apparent conflict of interest that might arise when the insurer represents the insured in a lawsuit against the insured and simultaneously formulates its defense against the insured for noncoverage." *Pacific Indemnity Co. v. Acel Delivery Service, Inc.*, supra.

Id. (quoting *Wilkinson*, 601 S.W.2d at 521–22. *See also id.* at 781 n.3 (explaining that it refused the writ of error in *Wilkinson* because there was "no reversible error" and making clear that it did not necessarily agree that the court of appeals correctly declared the law).

In *Ulico*, the Court emphasized that the *Wilkinson* decision held that based on an "apparent" conflict of interest that "might" arise it was justified in rewriting the insurance contract to include a risk not agreed to by the parties at the execution of the contract. *Id.* It cited several cases to support its conclusion that allegedly followed the principles enunciated in *Craddock*, but included defenses of noncoverage in its list of defense that might be waived or that it might be estopped from raising. *Id.* The Court, in response in *Ulico* said: "We do not agree with *Wilkinson's* statement to the effect that 'noncoverage' of a risk is the type of right an insurer can waive and thereby effect coverage for a risk not contractually assumed." *Id.* Rather "[a]n insurer's actions can result in it being estopped from refusing to make its insured whole for prejudice the insured suffers because the insurer assumed the insured's defense, but estoppel does not work to create a new insurance contract that covers a risk not agreed to by the contracting parties." *Id.* at 782. Accordingly, the Court found that no "right" of noncoverage that is subject to waiver by an insurer and that the cases relied upon by the *Wilkinson* court do not support its conclusion otherwise.

The Court then turned to each of those cases, criticizing *Wilkinson's* reliance upon them. In particular, with regard to the *Acel* decision, the Court said that *Wilkinson* failed to acknowledge that the insurer caused actual prejudice to its insured in that case. *Id.* Thus, there was not simply an "apparent" conflict that "might" cause prejudice. *Id.* And, the other two cases relied upon in *Wilkinson—Ferris* and *Murrah*—merely cited prior cases for the rule that waiver or estoppel could expand coverage for a risk not originally covered and applied it to situations in which the accident at issue was a covered risk. *Id.* at 783. Thus, despite the *Murrah* court's claim otherwise, the rule

simply was not "settled in this state." *Id.* at 784.

After rejecting *Wilkinson* and the case law upon which the decision was based, the Supreme Court of Texas turned to the issue of prejudice. *Id.* at 785. The Court began by noting that some situations exist in which an insurer "can and should be prevented from denying benefits that would have been payable had the claim been covered because the insured is actually prejudiced by the insurer's actions." *Id.* But it found that the possibility that an "apparent" conflict "might" arise was not sufficient justification for rewriting an insurance contract. In support of its claim, the Court looked to its decision in *Tilley* in which it held that Tilley had been prejudiced as a matter of law. The Court explained that in that case the prejudice prevented Employers from relying upon the late notice forfeiture provision of the policy, but it was not presented with the issue of whether the coverage of a policy could be expanded by waiver or estoppel to cover a risk or period of time for which policy premiums had not been paid. *Id.* at 786. Moreover, the Court said: "Nor did we hesitate to label the situation as an actual conflict of a most serious nature, not an 'apparent conflict of interest that might arise.'" *Id.* (quoting *Wilkinson*, 601 S.W.2d at 522). And, the Court said:

> When an insurer's defense of or controlling the defense of the insured prejudices an insured, as happened in *Tilley* and *Acel*, the insurer cannot escape liability for the detriment its actions cause its insured. In those cases, the insurer was estopped from refusing to pay the damages its actions caused, but there was no rewriting of the insurance contract. We think *Tilley's* rule, ethical rules applicable to attorneys defending insureds, and the doctrine of estoppel all work to protect an insured without the necessity of remolding the doctrines of waiver and estoppel to create an anomaly in the law by judicially rewriting agreements between insurers and insureds.

Id. Accordingly, the Court rejected *Wilkinson* because it allegedly would enable an insured to obtain more coverage that its policy provided even where an insurer provides a perfect (and free) defense to the insured under which it suffers no prejudice. *Id.* Thus, the Court concluded:

> In sum, if an insurer defends its insured when no coverage for the risk exists, the insurer's policy is not expanded to cover the risk simply because the insurer assumes control of the lawsuit defense. But, if the insurer's actions prejudice the insured, the lack of coverage does not preclude the insured from asserting an estoppel theory to recover for any damages it sustains because of the insurer's actions.

Id. at 787.

C. Concurring Opinion

Chief Justice Jefferson issued a concurring opinion, joined by Justice O'Neill, in which he attempted to clarify the majority's decision. The justices said:

> As [we] understand the Court's opinion, the Court (1) resolves the tension between our holdings in *Craddock* and *Ferris* by making it clear that while estoppel cannot create coverage, the benefits that would have been paid had the insurer not denied coverage remain

> the appropriate measure of damages; and (2) requires that the insured show prejudice in order to recover those damages.

Id. at 791.

Chief Justice Jefferson went on to note that the tension inherent in the holdings in *Craddock* and *Ferris* is explained "by the unique concerns involved when an insurer assumes control over its insured's defense without reserving the right to later deny coverage." *Id.* at 791–92. Quite simply, the concurring justices found that the general rule established in its precedent is that "'[t]he courts will not allow an insurer to lull an insured into a belief that coverage exists in a situation where it does not, or even where the insurer simply believes it does not' . . . and thereby induce the insured to give up the right to manage its own defense." *Id.* at 792 (citation omitted). Thus, in such circumstances, courts bind insurers to provide coverage without a further showing of harm because prejudice is conclusively presumed or the insured's loss of its control and management of its own defense is prejudicial in itself. *Id.* Some courts, however, have required further harm to be shown under the rule set forth in *Ferris* and *Wilkinson*. *Id.* at 792–93. Chief Justice Jefferson concluded:

> If the insurer defends without reserving its rights, and the insured shows prejudice, the insured is entitled to recover the benefits that would have been due under the policy. To that extent, it matters little whether a court says coverage was created or that the benefits are those that would have been payable had there been coverage; a rose by any other name would smell as sweet.

Id. at 793.

Commentary:

The Supreme Court's lengthy opinion actually may be quite innocuous. As clarified by the concurring opinion, it seems the Court merely emphasized that an insurer cannot be estopped to deny coverage, and thus estoppel cannot *create* coverage under an insurance policy that does not provide it. Rather, when an insurer assumes the defense of its insured without adequately reserving its rights, the insurer later denies coverage and the insured shows that it has been prejudiced by such actions, the insured is entitled to damages. Those damages, however, are measured by the coverage that would have existed had the insurer never denied coverage in the first instance. Accordingly, while seemingly a monumental decision, *Ulico* may actually be just a lesson in semantics.

IV. *Don's Building Supply, Inc. v. OneBeacon Ins. Co.*, 267 S.W.3d 20 (Tex. 2008)

On August 29, 2008, the Supreme Court of Texas addressed the issue of what "trigger" applies under an occurrence-based insurance policy in the context of latent "property damage" claims. In *Don's Building Supply, Inc. v. OneBeacon Insurance Co.*, 267 S.W.3d 20 (Tex. 2008), a unanimous Court held that, absent specific policy language to the contrary, "property damage" under a CGL policy occurs when actual physical damage to the property occurs—not when the damage was or could have been discovered. In essence, the Court rejected a "manifestation" trigger in favor of an "injury-in-fact" trigger. Even so, the opinion left open some important questions as to how the "injury-in-fact" trigger will apply in the duty to indemnify context and, in particular, how it will apply to "property

damage" that begins in one policy period but continues into periods covered by other policies.

A. Background Facts

Don's Building Supply, Inc. ("DBS") is a seller and distributor of a synthetic stucco product known as an Exterior Finish and Insulation System ("EIFS"). The product was installed on a number of homes from December 1, 1993 and December 1, 1996, during which time DBS was insured under consecutive CGL policies issued by Potomac Insurance Company of Illinois and assigned to OneBeacon Insurance Company ("OneBeacon"). From 2003 to 2005, numerous homeowners filed lawsuits against DBS, alleging that the EIFS was defective and not weather-tight, allowing moisture to enter the wall cavities. As a result of the water intrusion, the walls allegedly suffered wood rot and other damages. According to the homeowners, the damages began to occur after the first instance of water intrusion behind the EIFS, which allegedly occurred within six months to one year after the EIFS was applied to their homes. The homeowners claimed that the water intrusion caused extensive damage, reduced their property values, and necessitated a retrofit or replacement of the EIFS. *Id.* at 22–23.

In an apparent attempt to avoid a statute of limitations defense against their claims, the homeowners relied on the discovery rule. In particular, the homeowners alleged that the damages were "hidden from view" because the siding's exterior was undamaged and it was "not discoverable or readily apparent to someone looking at the surface until after the policy period ended." *Id.* at 23.

OneBeacon initially provided a defense to DBS, but it later filed a declaratory judgment action that sought a declaration that it had no duty to defend or indemnify DBS because the damages were not alleged to have become identifiable until after the OneBeacon policies had expired. The district court, relying on a "manifestation" trigger, agreed that the duty does not arise until the alleged damage becomes identifiable. DBS appealed to the Fifth Circuit Court of Appeals, which certified questions to the Supreme Court. *Id.*

B. The Certified Questions

1. When not specified by the relevant policy, what is the proper rule under Texas law for determining the time at which property damage occurs for purposes of an occurrence-based commercial general liability insurance policy?

2. Under the rule identified in the answer to the first question, have the pleadings in lawsuits against an insured alleged that property damage occurred within the policy period of an occurrence-based commercial general liability insurance policy, such that the insurer's duty to defend and indemnify the insured is triggered, when the pleadings allege that actual damage was continuing and progressing during the policy period, but remained undiscoverable and not readily apparent for purposes of the discovery rule until after the policy period ended because the internal damage was hidden from view by an undamaged exterior surface?

C. And the Trigger Is . . . Injury-in-Fact

At the outset, the Court acknowledged that insurance policies are contracts and that it must effectuate the parties' expressed intent. In doing so, it enforces such contracts as

written, so long as the language is unambiguous. If, however, such language is ambiguous, it is construed in favor of coverage. In light of such principles, the court turned to the relevant language in the OneBeacon policies, which provided as follows:

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

Id. at 23–4. The policies further provide:

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

> (1) The "bodily injury" or "property damage" is caused by an "occurrence" that takes place in the "coverage territory;" and
>
> (2) The "bodily injury" or "property damage" occurs during the policy period.

Id. at 24. The policy defines an "occurrence" as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions." *Id.* And, finally, "property damage" is defined 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 shall be deemed to occur at the time of the "occurrence" that caused it.

Id.

Looking at those provisions, and giving them their plain meaning, the Court held that property damage occurred when actual physical injury to the property at issue occurred. That is, property damage occurs at the time when a home that is the subject of an underlying lawsuit suffers wood rot or other physical damage. The Court found this to be true regardless of the date that the physical damage was or could have been discovered. The date of discovery, according to the Court, "is irrelevant." *Id.* In other words, the Court adopted what other courts have called the "actual injury" or "injury-in-fact" approach by which an insurer must defend any claim of physical property damage that occurred during the policy period. *Id.* at 25.

In adopting that trigger theory, the Court recognized the varying approaches adopted by other courts and the Fifth Circuit's note that the issue has not been uniformly resolved in Texas and across the country. *Id.* at 25–26. In particular, as it has long been the majority rule in Texas, the Court primarily discussed the "manifestation rule" that imposes a duty on an insurer only if property damage became evident or discoverable during the insurer's policy period. *Id.* at 26. The Court noted, though, that even the manifestation trigger has variations with some courts requiring actual discovery and others looking to when the damage *could have been* discovered. And, even then, courts taking the latter approach vary as to how easily discoverable the damage must be to trigger a duty to defend. *Id.* at 27. Importantly, the court discussed decisions in which courts use the word "manifest" and have been cited as adopting the manifestation rule even though such

cases did not deal with *latent* property damage—the point at which the manifestation and the injury-in-fact trigger diverge. *Id.* The Court concluded that such cases actually can be read as adopting the same injury-in-fact trigger it adopted, and that their use of the word "manifest" is used as a synonym for "results in," "rather than [for] drawing a distinction between the actual occurrence of damage and the later discovery or obviousness of damage." *Id.*

The Supreme Court then acknowledged that two Texas appellate courts had adopted an "exposure rule" that triggers coverage so long as the plaintiff is exposed to the ultimately injurious agent during the insurer's policy period. *Id.* at 28. The Court, however, noted that "what some courts call the 'exposure rule' may actually be what others would call the injury-in fact rule." *Id.* Other courts adopt multiple or continuous triggers or, in the alternative, a rule that looks to the date of the negligent conduct rather than the resulting injury. Still others, like courts in California, adopt a manifestation rule under first-party insurance policies, but a continuous-injury rule under liability insurance policies. *Id.* Finally, the Court said: "A related if not overlapping body of law, which we do not explore today, addresses when coverage is triggered on bodily injury claims under CGL and other policies." *Id.*

As for the manifestation rule, which was the theory urged by OneBeacon and followed by most Texas courts, the Court said: "the policy before us simply makes no provision for it." *Id.* at 29. Looking at the plain language of the policy, the court found that "whatever practical advantages a manifestation rule would offer to the insured or the insurer, the controlling policy language *does not* provide that the insurer's duty is triggered only when the injury manifests itself during the policy term, or that coverage is limited to claims where the damage was discovered or discoverable during the policy period." *Id.* (emphasis added). In turn, at least in property damage cases, the Court also made clear that the policy language does not support the use of an exposure rule either. Notably, "[t]he policy does not state that coverage is available if property is, during the policy period, exposed to a process, event, or substance that *later results in* bodily injury or physical injury to tangible property." *Id.* (emphasis added).

Taking a literal approach to the policy language, the Court explained that "[t]his policy links coverage to damage, not damage detection." *Id.* And, by applying the manifestation rule, the Court was concerned that the line between occurrence-based and claims-made policies would be blurred. In any event, the Court noted that had insurers wanted a policy where coverage depends on manifestation of damage, then insurers could adopt such a policy and seek its approval from Texas insurance regulators. *Id.* Moreover, despite OneBeacon's claim that the manifestation rule is easier to apply, the Court said that it "does not eliminate the need to address sometimes nettlesome fact issues." *Id.* For example, at least one version of the manifestation rule requires proof not of when the claimant actually identified the damage, but when it was *capable* of such identification. *Id.* In that case, the injury-in-fact rule may be just as easy—if not easier—to apply than the manifestation rule.

Further, in addressing the "ease of application" argument, the Court recognized that pinpointing the moment of injury retrospectively can be difficult in some cases, "but we cannot exalt ease of proof or administrative convenience over faithfulness to the policy language; our confined task is to review the contract, not revise it." *Id.* In addition, the Court found that its holding

was consistent with scholarly authority. *Id.* at 30 (citing 7A John Alan Appelman, Insurance Law and Practice § 4491.01 (Walter F. Berdal ed., 1979); 7 Couch on Insurance § 102.22)). As explained in Couch on Insurance, "the manifestation rule 'obviously gives short shrift to the specific terms inserted in the policy to address the risk exposure.'" *Id.* According to the Court, though, Texas law does not. *Id.* In closing its discussion of the first certified question, the Court made clear that it was not adopting a blanket rule for all CGL policies; instead, it held that an insurer's duty to defend should be determined by the language in the insurance policy, which can vary from one policy to another. *Id.*

Having adopted the injury-in-fact rule, the Court turned to the second certified question and promptly determined that OneBeacon had a duty to defend DBS in the underlying lawsuits. *Id.* at 31. In particular, the Court found that under the rule it had adopted, "a plaintiff's claim against DBS that *any amount* of physical injury to tangible property occurred during the policy period and was caused by DBS's allegedly defective product triggers OneBeacon's duty to defend." *Id.* (emphasis added). The Court further noted that the duty is "not diminished because the property damage was undiscoverable . . . until after the policy period ended." *Id.* at 31–32. Likewise, the Court held that the duty to defend is not dependent on whether "DBS has a valid limitations defense." *Id.*

What the Court did not say is how many of the OneBeacon policies were triggered. In a footnote, the Court further explained that in the case before it, the defective EIFS was installed on the homes during the three-year policy period of the OneBeacon policies. *Id.* at 32, n.45. Accordingly, the Court concluded that it need not address a situation where property damage occurred during the course of a continuing process but began before inception of the policy at issue. *Id.* And, the Court declined to address OneBeacon's indemnity obligations should it be determined that the damage commenced during a OneBeacon policy period but continued beyond that period (perhaps into periods covered by other policies). *Id.*

D. The Aftermath

A month after the Supreme Court of Texas' decision in *Don's Building*, the Dallas Court of Appeals applied the decision in another case involving the same company. *See Union Ins. Co. v. Don's Building Supply, Inc.*, 266 S.W.3d 592 (Tex. App.—Dallas 2008, pet. filed). In that case, the appellate court applied the Supreme Court's ruling and found that Union Insurance owed Don's Building a defense under their 1996, 1997 and 1998 insurance policies. *Id.* at 595. Notably, that court also rejected the insurer's contention that the policies were not triggered because the claimants did not own the home at issue during those policy periods. *Id.* In doing so, the appellate court stated: "While ownership of the home was not an issue in *OneBeacon*, we do not believe this distinction warrants departure from the supreme court's analysis." *Id.* at 596.

The Dallas Court of Appeals again addressed the trigger issue in *Thos. S. Byrne, Ltd. v. Trinity Universal Insurance Co.*, 2008 WL 5095161 (Tex. App.—Dallas Dec. 4, 2008, no pet. h.). There, the appellate court reversed the trial court's grant of summary judgment in favor of the insurers, finding that the insurers owed a defense to their additional insured, Thos. S. Byrne. Notably, Thos. S. Byrne was the general contractor on the project and sought coverage under its subcontractors' insurance policies as an additional insured. The

subcontractors were not named as defendants, but they were referenced by name in the allegations against Thos. S. Byrne.[1]

In finding that a defense was owed, the court noted that the insurance policies at issue contained identical "occurs during the policy period" language as that in *Don's Building Supply*, and thus it was obligated to apply the "injury-in-fact" rule announced therein. As such, the court found two allegations in the underlying pleading to be "irrelevant" because they addressed when the owner discovered property damage or when it became manifest. *Id.* at *7. The court then liberally applied Texas' "eight corners" rule, analyzing each of the remaining allegations and finding that open-ended claims of the occurrence of damage created the potential for damage during the insurers' policy periods. As such, a defense was owed to Thos. S. Byrne.

Then, on December 23, 2008, the Fifth Circuit Court of Appeals issued its opinion adopting the Supreme Court of Texas' answers to the certified questions. *Don's Building Supply, Inc. v. OneBeacon Ins. Co.*, 2008 WL 5341382 (5th Cir. Dec. 23, 2008). In doing so, the court said:

> The effect of the answers provided by the Supreme Court of Texas to our certified questions is to overrule [*American Home Assurance Co. v.*] *Unitramp* [*Ltd.*, 146 F.3d 311, 313 (5th Cir. 1998)] and the relevant portions of [*Guaranty National Insurance Co. v.*] *Azrock* [*Industrial Inc.*, 211 F.3d 239, 246–47 (5th Cir. 2000)].

Don's Building Supply, 2008 WL 5341382, at *2.

Other courts also have utilized the Court's analysis *Don's Building* in other scenarios. *See Central Mut. Ins. Co. v. KPE Firstplace Land, LLC*, 271 S.W.3d 454 (Tex. App.—Tyler 2008, no pet.) (finding that an insurer had not met its burden regarding application of an exclusion utilizing the word "occurs" because the insurer could not show that the damage at issue occurred after the building had been vacant for more than sixty days only that it manifested at that time); *Trammell Crow Residential Co. v. Virginia Surety Co.*, 2008 WL 5062132 (N.D. Tex. Dec. 1, 2008) (refusing to apply the "injury-in-fact" trigger theory to a Coverage B claim because the policy specified that the "offense" take place during the policy period); *Pine Oak Builders, Inc. v. Great Am. Lloyds Ins. Co., Ltd.*, No. 06-0867 (Tex. Feb. 13, 2009) (adhering to its holding in *Don's Building Supply*, and remanding to the trial court so that the "actual injury rule" could be applied and a determination made as to whether the property damage claims at

[1] This case serves as an interesting contrast to *D.R. Horton—Texas, Ltd. v. Markel Int'l Ins. Co., Ltd.*, 2006 WL 3040756 (Tex. App.—Houston [14th Dist.] Oct. 26, 2006, pet. denied), and *Pine Oak Builders, Inc. v. Great Am. Lloyds Ins. Co.*, 2006 WL 1892669 (Tex. App.—Houston [14th Dist.] July 6, 2006, pet. granted), which were recently addressed by the Court. In those cases, the admissibility of extrinsic evidence for purposes of determining the duty to defend also was at issue, but under factual scenarios in which the subcontractor that did the work was not mentioned at all—generally or specifically. As is discussed later in this paper, the court denied the petition in *D.R. Horton*, and rejected the use of extrinsic evidence in *Pine Oak* because the evidence contradicted a factual allegation in the underlying lawsuit. *D.R. Horton—Texas, Ltd. v. Markel Int'l Ins. Co., Ltd.*, No. 06-1018 (Tex. Feb. 13, 2009) (denying petition for review); *Pine Oak Builders, Inc. v. Great Am. Lloyds Ins. Co.*, No. 06-0867 (Tex. Feb. 13, 2009). Thus, to date, the Supreme Court of Texas still has not "officially" recognized any exception to the "eight corners" rule. *See, e.g., Zurich Am. Ins. Co. v. Nokia, Inc.*, 268 S.W.3d 487, 497–98 (Tex. 2008).

issue fell within the terms of Great American's insurance policies).

Commentary:

The injury-in-fact trigger is the most academically honest trigger and the one that is most in line with the standard ISO policy language. That being said, the main criticism of the injury-in-fact trigger always had been the perceived difficulty of determining when the damage actually occurred. To its credit, the Court refused to "exalt ease of proof or administrative convenience over faithfulness to the policy language." And, the Court was correct in noting that the so-called manifestation trigger certainly has caused confusion among courts, insureds, and insurers as to its correct application.

The opinion undoubtedly will result in a change as to how insurance carriers approach property damage claims—especially in the context of construction defect claims. Most, if not all, insurance carriers assumed that Texas was a manifestation state. Now, that assumption is no longer valid and insurers will have to re-examine their obligations to respond to "property damage" claims. An insurer, by way of example, can no longer deny coverage simply because the underlying claimant invokes the discovery rule. Similarly, an insurer can no longer deny coverage simply because the underlying claimant alleges "discovery" of the damage after the insurer's policy period has expired. Even so, the Court's opinion left open some important issues. For example, the Court did not address what would happen in circumstances where the property damage occurred in the course of a continuing process—but began before the inception of the term of the policy at issue. Likewise, in declining to address the duty to indemnify, the Court left open the issue of how insurers will adjust losses where property damage begins during the policy period but continues into other policy periods. Most likely, although not explicitly discussed, these issues will result in more frequent application of the "known loss" or "loss in progress" doctrines as well as application of specific policy language dealing with continuous losses that was incorporated into standard ISO forms in 2001 (f/k/a the "Montrose Endorsement"). The opinion likely also will result in a debate as to whether Texas follows an "all sums" approach to allocation or whether losses can be pro-rated among consecutively triggered policies. Finally, the Court was careful to limit its holding to the specific policy language before it. Accordingly, when dealing with manuscript forms, it will be important to carefully review the policy language before assuming that an injury-in-fact trigger applies.

Notably, a motion for rehearing filed by OneBeacon was denied on November 14, 2008.

V. *Trammell Crow Residential Co. v. Virginia Surety Co., Inc.*, 2008 WL 5062132 (N.D. Tex. Dec. 1, 2008)

On December 1, 2008, Chief Judge Sidney A. Fitzwater of the Northern District of Texas issued an opinion touching on the extent of an insurer's duty to defend, as well as its liability for damages under the Prompt Payment of Claims Act. *See Trammell Crow Residential Co. v. Virginia Surety Co., Inc.*, 2008 WL 5062132 (N.D. Tex. Dec. 1, 2008). The court held that Virginia Surety owed a defense to its insured against allegations of discrimination against persons with disabilities. In addition, the court applied *Lamar Homes, Inc. v. Mid-Continent Casualty Co.*, 242 S.W.3d 1 (Tex. 2007), in determining that Virginia Surety was obligated to pay 18% interest to Trammell Crow for violating the Prompt Payment of

Claims Act. After ruling on those issues, the court also denied the insurer's motion for summary judgment on Trammell Crow's unfair settlement practices claims, as well as its motions for severance, abatement and leave to file a response to Trammell Crow's surreply. The court's rulings on the duty to defend and the Prompt Payment of Claims Act, however, serve as the focus here.

A. Background Facts

On July 9, 2007, The Equal Rights Center (the "ERC") filed a lawsuit against Trammel Crow Residential Company ("Trammell Crow") in the U.S. District Court for the District of Columbia (the "*ERC Litigation*"), alleging that Trammell Crow was liable for discriminating against persons with disabilities in violation of the Fair Housing Act (the "FHA") and the Americans with Disabilities Act of 1990 (the "ADA"). In particular, ERC alleged that Trammell Crow discriminated against persons with disabilities by "designing, constructing, controlling, managing, and/or owning covered multifamily dwellings . . . in such a manner as to deny persons with disabilities access to, and the use of, these facilities." *Id.* at *1. Further, ERC contended that the discriminatory conduct injured the ERC and its members—most of whom are persons with disabilities. ERC sought "such damages as would fully compensate the ERC for the injuries incurred as a result of Trammell Crow's discriminatory housing practices and conduct." *Id.*

Virginia Surety Company, Inc. issued an insurance policy to Trammell Crow that contained a "Personal and Advertising Injury Liability Coverage Endorsement," which provided that Virginia Surety owed Trammell Crow a defense against any suit seeking damages for a covered "personal injury." A covered personal injury is one that arises out of an offense committed in the coverage territory during the policy period. And, the term "personal injury" specifically is defined as including injury arising out of discrimination because of physical disability. *Id.* Nevertheless, when Trammell Crow notified Virginia Surety of the *ERC Litigation* on November 13, 2007, Virginia Surety denied that it owed a defense against the claims. *Id.* at *2. As a result, Trammell Crow filed its suit alleging that Virginia Surety had breached its contract, had a continuing defense duty and that it violated Chapter 542 of the Texas Insurance Code for failing to promptly provide a defense.

B. The Court Finds that Virginia Surety Owed a Defense to Trammell Crow

Virginia Surety claimed that no defense existed because "(1) the ERC Litigation does not allege facts that constitute a "personal injury" under the Policy; (2) the alleged discrimination was not committed during the Policy period; (3) the 'willful violation of ordinance' exclusion precludes coverage; and (4) the fortuity doctrine bars coverage." *Id.* at *3. Addressing the allegations in the petition, the court rejected Virginia Surety's position, finding that the ERC clearly alleged an offense under the definition of "personal injury" and that it suffered the injury—not just that its members did. *Id.* It also rejected Virginia Surety's contention that the ERC could not allege a personal injury because *it* was not personally discriminated against because the policy did not require a plaintiff to personally suffer the discrimination. *Id.* at *4. Rather, the policy requires Virginia Surety to defend its insured whenever a plaintiff seeks damages for personal injury that arises out of such discrimination. Under the facts before it, the court held that the ERC sought damages because of a covered personal injury. *Id.*

The court then turned to Virginia Surety's claim that the personal injury alleged did not occur during the policy period. *Id.* at *5. In doing so, Virginia Surety relied on the Supreme Court of Texas' recent decision in which the Court held that an insurer's duty to defend only is triggered by an "injury in fact" that occurs during the policy period. *Id.* (citing *Don's Building Supply, Inc. v. OneBeacon Insurance Co.*, 267 S.W.2d 20 (Tex. 2008). The Northern District of Texas found *Don's Building Supply* to be inapposite, however, as the policy at issue before the court in *Trammell Crow* required only that a "personal injury" "arise[] out of an offense committed during the policy period." *Id.* Thus, it is the *offense* rather than the *injury* resulting from that offense that triggers an insurer's defense duty under Coverage B. Accordingly, *Don's Building Supply* was inapplicable to this case. And, looking at the allegations in the *ERC Litigation* the court found that the ERC alleged that Trammell Crow—at a minimum—owned properties covered by the policy during the policy period and that the personal injury arose out of that ownership. As such, the court ruled that the ERC "seeks by its lawsuit damages for an alleged offense that falls within the Policy's 'personal injury' coverage." *Id.* at *6.

The court also rejected Virginia Surety's reliance on an exclusion for the willful violation of an ordinance and the fortuity doctrine. With regard to the exclusion, the court reiterated that an insurer carries the burden to prove the application of an exclusion or limitation and that Virginia Surety had failed to meet that burden, as it did not quote the provision it sought to invoke and did not establish that the ERC sought only damages arising from "willful" violations of the FHA and the ADA. *Id.* at *6. With respect to the fortuity doctrine, the court again noted that the insurer held the burden and again failed to meet it. In particular, while Virginia Surety acknowledged that application of the fortuity doctrine is subject to Texas' "eight corners" rule, the insurer failed to cite any allegations in the *ERC Litigation* that would indicate that Trammell Crow knew or should have known of an ongoing loss when it purchased its policy. The court found Virginia Surety's argument "logically fallacious" because it assumed that because the ERC alleged that Trammell Crow had been violating the FHA and the ADA since 1991 that Trammell Crow *knew* that it had been violating those Acts. *Id.* at *7. The court disagreed because that is not what the allegations stated and because none of the alleged statutory violations require intentional acts or a knowing violation. *Id.* Because Virginia Surety pointed to no factual allegations to support its argument and the court found none, the court dismissed Virginia Surety's reliance on the fortuity doctrine.

In light of the foregoing, the court found that Trammell Crow was entitled to a defense from its insured and granted summary judgment in its favor on that issue. Moreover, the court held that such duty to defend the insured was ongoing and also granted summary judgment in Trammell Crow's favor on that claim. *Id.* at *7–*8.

C. Virginia Surety Breached Its Contract

The parties did not dispute that they have a valid and enforceable contract and that Trammell Crow performed its duties under the contract. The primary argument was that Virginia Surety had not breached the contract because it owed no defense to Trammell Crow. Because the court found otherwise, however, Trammell Crow had established the first three elements necessary for a finding of a breach of contract. The fourth element, that Trammell Crow

suffered damages as a result of the breach, then was addressed by the court. *Id.* at *8.

The court noted that Trammell Crow did not seek summary judgment on the amount of its damages, but it was required to show that it suffered some damages to satisfy that element of its cause of action. In that regard, Virginia Surety did not argue that Trammell Crow had not suffered damages, only that the affidavit filed to support its claim of damages was not the "best evidence" of its defense costs and that it was incompetent evidence for establishing that Virginia Surety had paid nothing toward the defense. *Id.* at *8–*9. The court rejected both arguments though, finding that the "best evidence" rule had no application to the case and that the affidavit was competent because it was made by Trammell Crow's Risk Management Director, who was familiar with the claim and would have known whether Virginia Surety contributed to the defense. *Id.* As such, the court found that all four elements were met and that Virginia Surety breached its contract. *Id.* at *9.

D. Virginia Surety Violated the Prompt Payment of Claims Act

Under the Prompt Payment of Claims Act (codified at Sections 542.051–.061 of the Texas Insurance Code), insurers are prohibited from delaying payment of first-party claims. The federal court noted that the Supreme Court of Texas "recently held that an insured's right to a defense benefit is a first-party claim, and that the Prompt Payment of Claims Act 'may be applied when an insurer wrongfully refuses to promptly pay a defense benefit owed to the insured.'" *Id.* (quoting *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 242 S.W.3d 1, 20 (Tex. 2007)). When an insurer violates the Prompt Payment of Claims Act, it is liable to pay the insured, "in addition to the amount of the claim, interest on the amount of the claim at the rate of 18 percent a year as damages, together with reasonable attorney's fees." *Id.* (quoting TEX. INS. CODE § 542.060 (Vernon 2007)).

Trammell Crow urged that Virginia Surety violated the Prompt Payment of Claims Act because it denied a defense to Trammell Crow on December 26, 2007 and had not contributed any amount to the defense. In the meantime, Trammell Crow claimed that it had paid significant defense costs in the *ERC Litigation*. *Id.* at *10. Because Virginia Surety had delayed in providing that defense benefit for more than 60 days, Trammell Crow contended that the Act had been violated as a matter of law.

In retort, Virginia Surety argued that it was not liable for damages because Trammell Crow never submitted its legal bills or invoices for expenses it incurred in defending itself in the underlying litigation. More specifically, Virginia Surety claimed that no damages exist under the Act "unless the insured retains counsel in the underlying lawsuit, begins receiving statements for legal services, *and such statements are submitted to the insurer*." *Id.* (citing *Lamar Homes*, 242 S.W.3d at 19; TEX. INS. CODE § 542.056(a)). Further, Virginia Surety said that those invoices are the last piece of information necessary to value the insured's loss. While the Northern District of Texas "agree[d] that proof of the insured's defense costs are necessary to calculate the damages for which the insured is liable, it disagree[d] with the premise that an insurer cannot be liable under the [] Act *unless* the insured has submitted statements of its defense costs to the insurer." *Id.*

Turning to *Lamar Homes*, the court said that the Supreme Court of Texas concluded that the loss resulting from the wrongful denial of a defense obligation "is quantified after the insured retains legal counsel and begins

receiving statements for legal services." *Id.* (quoting *Lamar Homes*, 242 S.W.3d at 19). The Supreme Court said:

> These statements or invoices are the last piece of information needed to put a value on the insured's loss. And when the insurer, who owes a defense to its insured, fails to pay within the statutory deadline, the insured matures its right to reasonable attorney's fees and the eighteen percent interest rate specified by the statute.

Id. (quoting *Lamar Homes*, 242 S.W.3d at 19 (internal citations omitted)). The Northern District of Texas said that Virginia Surety "seriously misquote[d]" the second sentence of that quote by stating in its brief that:

> *Only* [And] when *an* [the] insurer, who owes a defense to its insured, fails to pay *the submitted defense costs* within the statutory deadline *of the Texas Insurance Code*, the insurer matures its right to reasonable attorney's fees and the eighteen percent interest rate specified by the statute.

Id. at *11 (quoting Virginia Surety's brief and emphasizing language added by the insurer (in italics) and taken away (in brackets)). By altering the quote without acknowledging the alteration, the court found that Virginia Surety's argument was very misleading.

In any event, the court disagreed with Virginia Surety's position, finding that it ran counter to *Lamar Homes'* reasoning that the insured suffers actual loss when the defense obligation is rejected. The court interpreted *Lamar Homes* to hold that liability arises upon the wrongful rejection of a defense, but attorneys' fees cannot be awarded and prejudgment cannot accrue until the defense costs actually are incurred. "In other words, there can be a determination of liability without a calculation of damages." *Id.*

Commentary:

Most Texas insurance law commentators interpreted *Lamar Homes* to require the actual submission of defense costs invoices to an insurer that has denied a defense in order to trigger liability under the Prompt Payment of Claims Act. As such, insureds have been advised to submit redacted invoices to the insurer as received. The *Trammell Crow* case suggests, however, that actual submission is not necessary. While Judge Fitzwater's logic is persuasive, and although the submission of invoices ***should not be necessary*** when an insurer denies a defense, the safest approach still seems to be to submit redacted invoices as received—at least until the issue is addressed by the Supreme Court of Texas.

VI. *Mid-Continent Casualty Co. v. JHP Development, Inc.*, 2009 WL 189886 (5th Cir. Jan. 28, 2009)

On January 28, 2009, the Fifth Circuit Court of Appeals issued an opinion addressing exclusions J(5) and J(6) of the standard CGL insurance policy. *See Mid-Continent Cas. Co. v. JHP Development, Inc.*, 2009 WL 189886 (5th Cir. Jan. 28, 2009). The court affirmed the Western District of Texas' opinion in which it was found that Mid-Continent owed its insured, JHP Development, a defense and indemnity for damages awarded to TRC Condominiums, Ltd. in a state court lawsuit between JHP and TRC, stemming from JHP's defective construction of a condominium project in San Antonio. In reaching its decision, the court of appeals rejected Mid-Continent's claim that J(5) applied because four of the

five condominiums in the project were left unfinished. Turning to J(6), the court said that the "that particular part" language must mean something under Texas law, and thus the exclusion did not bar coverage for damage to otherwise non-defective portions of the condominiums. Finally, the Fifth Circuit applied the Supreme Court of Texas' recent decision in *Evanston Insurance Co. v. ATOFINA Petrochemicals, Inc.*, 256 S.W.3d 660 (Tex. 2008), and held that Mid-Continent is bound by the default judgment awarded to TRC against JHP in the underlying lawsuit.

A. Background Facts

In January 1999, TRC and JHP entered into a construction contract wherein JHP agreed to build a four-story, five-unit condominium project. Only the model condominium was to be completed under the construction plans, leaving the remaining four units unfinished so that the new owner for each unit could choose how the unit was finished. By spring 2001, the model unit was completed. The remaining units still needed to be painted, floored, plumbed, electrical fixtures installed, and the HVAC systems activated.

Sometime beginning in the summer or fall of 2001, water intrusion problems developed with the condominiums. In particular, it was determined that JHP failed to properly water-seal the exterior finishes and retaining walls. As a result, large quantities of water penetrated the units, damaging building materials and interior finishes. JHP refused to repair the damage and complete the work, so TRC terminated the company's contract.

On December 12, 2002, TRC retained a substitute contractor who repaired and completed the condominiums. That contractor spent more than $400,000 investigating, demolishing, repairing and replacing the non-defective interior finishes and wiring damaged by the water intrusion.

JHP notified Mid-Continent of the problems on the TRC project and sought coverage under its CGL policy. On May 1, 2003, Mid-Continent denied coverage, claiming there was no "occurrence" or "property damage" as those terms were defined under the insurance policy. In addition, Mid-Continent alleged that various exclusions applied to bar coverage. Thereafter, in October 2003, TRC filed suit against JHP, and JHP tendered defense of the claim to Mid-Continent. Again, Mid-Continent denied coverage for the claim and refused to provide a defense. Ultimately, in December 2003, a default judgment was entered against JHP in excess of $1.5 million.

Mid-Continent then filed a declaratory judgment action against JHP and TRC, seeking a declaration that (1) JHP was not entitled to coverage; (2) no defense or indemnity duties existed; (3) TRC was not entitled to recover any sums as a third-party beneficiary or judgment creditor; and (4) the default judgment was not binding on Mid-Continent. JHP never filed an answer in the declaratory judgment action. TRC, in contrast, filed a counterclaim against Mid-Continent. Mid-Continent and TRC ultimately filed cross-motions for summary judgment on the coverage issues in the district court. That court granted TRC's motion and denied Mid-Continent's. The Western District of Texas ruled that there was an "occurrence" and "property damage," none of the exclusions applied to bar coverage and the default judgment in the underlying suit was binding on Mid-Continent.

On appeal, Mid-Continent abandoned its argument regarding the lack of an "occurrence" or "property damage" in light of the Supreme Court of Texas' opinion in

Lamar Homes, Inc. v. Mid-Continent Casualty Co., 242 S.W.3d 1 (Tex. 2007). Instead, the insurer urged the appellate court to find that exclusions J(5) and J(6) barred coverage and that, in any event, the default judgment against its insured was not binding on Mid-Continent because there was not a fully adversarial trial.

B. The Exclusions

Exclusions J(5) and J(6) in the standard CGL policy are as follows:

> This insurance does not apply to:
>
> ***
>
> j. Property damage to:
>
> ***
>
> (5) That particular part of real property on which you or any contractor or subcontractors working directly or indirectly on your behalf are performing operations, if the 'property damage' arises out of those operations; or
>
> (6) That particular part of any property that must be restored, repaired or replaced because "your work" was incorrectly performed on it.

Further language in the standard insurance policy notes that J(6) "does not apply to 'property damage' included in the 'products-completed operations hazard.'" "Your work" is defined in the policy as "work or operations performed by you or on your behalf."

As recognized by the Fifth Circuit, both J(5) and J(6) are known as "business risk" exclusions, "designed to exclude coverage for defective work performed by the insured." *JHP*, 2009 WL 189886, slip op. at 5. Moreover, unlike exclusion L which applies to completed operations, both J(5) and J(6) apply to damages that occur during the course of construction.

1. Exclusion J(5)

After explaining the applicable legal standards under Texas law, the court turned to the applicability of the exclusions to the facts at hand. With respect to J(5), the parties were in agreement that "the use of the present tense 'are performing operations'" in the exclusion clarifies that the exclusion applies only to property damage that occurred during the performance of JHP's construction operations. The parties, however, disagreed as to whether JHP was "performing operations" when the water intrusion took place. TRC argued that JHP was not "performing operations" because construction had been suspended until the four units were purchased. Mid-Continent, on the other hand, claimed that the project involved ongoing construction because the units remained unfinished.

Citing *Lamar Homes* and *CU Lloyd's of Texas v. Main Street Homes*, 79 S.W.3d 687 (Tex. App.—Austin 2002, no pet.), as well as *The Oxford English Dictionary*, the court explained that "performing operations" means "the active performance of work." According to the court, "[t]he prolonged, open-ended, and complete suspension of construction activities pending the purchase of the condominium units does not fall within the ordinary meaning of 'performing operations.'" Further, "[a]lthough JHP intended to eventually complete construction work once the units were sold, an actor is not actively performing a task simply because he has not yet completed it but plans to do so at some point in the future." And, the cases cited by Mid-Continent actually all support that position, as none of

them suggests that the exclusion applies to damage occurring during a prolonged suspension of construction work. Because JHP was not actively engaged in construction work at the time of the water intrusion, the exclusion did not apply. *JHP*, 2009 WL 189886, slip op. at 7–8.

2. Exclusion J(6)

Turning to J(6), the court's focus was on the phrase "that particular part." TRC urged the court to find that it meant the exclusion only barred coverage for that portion of the condominium project that was the subject of the defective work at issue (i.e., the inadequately waterproofed exterior portions of the condominium units), as opposed to the otherwise non-defective work that was damaged as a result of the defective work (i.e., sheetrock, studs, wiring and flooring). Mid-Continent, on the other hand, argued that the phrase applied to the entire condominium project, and thus it excluded all the damage resulting from JHP's work.

In support of its position, Mid-Continent relied on *Southwest Tank & Treater Manufacturing Co. v. Mid-Continent Casualty Co.*, 243 F. Supp. 2d 597 (E.D. Tex. 2003), in which the court found that J(6) barred coverage for damage to an entire tank that the insured was hired to install. The Fifth Circuit, however, noted that its recent decision in *Gore Design Completions, Ltd. v. Hartford Fire Insurance Co.*, 538 F.3d 365 (5th Cir. 2008), had acknowledged that the *Southwest Tank* court "focused on the insured's work on the entire tank that was damaged, rather than on a particular part." *Id.* at 371 n.8. Accordingly, the case had no bearing on the instant analysis where the defective work at issue was performed on a discrete portion of an overall project. *JHP*, 2009 WL 189886, slip op. at 9.

Gore, in fact, lent support to TRC's position. In that case, an insured subcontractor incorrectly wired a component for an in-flight entertainment/cabin management system on a commercial plane. As a result, substantial damage occurred in the plane's electrical system. The Fifth Circuit rejected the insurer's argument that J(6) applied to the entire aircraft. In particular, the court found that "[the insurer's] reading of the exclusion reads out the words 'that particular part.'" *Gore*, 538 F.3d at 371. The court said that if the exclusion were meant to bar coverage for the entire property, then the exclusion should not include the language "that particular part." *JHP*, 2009 WL 189886, slip op. at 9–10. As the Fifth Circuit noted:

> *Gore* makes clear that the "[t]hat particular part" language of exclusion j(6) limits the scope of the exclusion to damage to parts of the property that were actually worked on by the insured, but *Gore* did not address the issue presented in this case: whether the exclusion bars recovery for damage to any part of a property worked on by a contractor that is caused by the contractor's defective work, including damage to parts of the property that were the subject of only nondefective work, or whether the exclusion only applies to property damage to parts of the property that were themselves the subject of the defective work.

JHP, 2009 WL 189886, slip op. at 10.

Turning back to the case at bar, the Fifth Circuit held that "[t]he plain meaning of the exclusion . . . is that property damage only to parts of the property that were themselves the subjects of the defective work is excluded." Further, the court said, "[t]he narrowing 'that particular part' language is

used to distinguish the damaged property that was itself the subject of the defective work from other damaged property that was either the subject of nondefective work by the insured or that was not worked on by the insured at all." *Id.* at 10–11.

The court then said that even if another reasonable construction of the exclusion existed, the court would still be required under Texas law to construe it in favor of coverage. Accordingly, the court said:

> We find that exclusion j(6) 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. at 11.

After reaching its conclusion, the court clarified that its decision did not conflict with other Texas court decisions appearing to support a different interpretation. *See, e.g., T.C. Bateson Constr. Co. v. Lumbermens Mutual Casualty Co.*, 784 S.W.2d 692, 694–95 (Tex. App.—Houston [14th Dist.] 1989, writ denied) (noting that the exclusion there was broader in scope than the standard J(6) exclusion); *Eulich v. Home Indem. Co.*, 503 S.W.2d 846, 849–50 (Tex. Civ. App.—Dallas 1973) (same). In addition, other appellate court decisions in Texas interpreting similar exclusions also supported the Fifth Circuit's finding. *See, e.g., Dorchester Dev. Corp. v. Safeco Ins. Co.*, 737 S.W.2d 380, 382 (Tex. App.—Dallas 1987, no pet.) ("[I]f defective work is performed by or on behalf of the insured, and such defective work causes damage to other work of the insured which was not defective, then there would be coverage for repair, replacement or restoration of the work which was not defective."), *abrogated on other grounds by Don's Bldg. Supply, Inc. v. OneBeacon Ins. Co.*, 267 S.W.3d 20 (Tex. 2008). The Fifth Circuit also explained that the South Carolina Supreme Court's decision in *Century Indem. Co. v. Golden Hills Builders, Inc.*, 561 S.E.2d 355 (S.C. 2002), was inapposite. There, in finding that J(6) barred coverage for water damage to an entire house and not just that portion that was defectively constructed—the exterior synthetic stucco—the court relied on South Carolina law, which gives great weight to the general purpose of commercial general liability insurance. That view, however, has been specifically rejected in Texas. *See Barnett v. Aetna Life Ins. Co.*, 723 S.W.2d 663, 666 (Tex. 1987) (finding that the mere fact that a policy is designated as a commercial general liability policy is not grounds for overlooking the actual language contained in the policy). As the Supreme Court of Texas said in *Lamar Homes*, such "preconceived notion[s] . . . must yield to the policy's actual language," and "coverage for [business risks] depends, as it always has, on the policy's language, and thus is subject to change when the terms of the policy change." *Lamar Homes*, 242 S.W.3d at 13–14.

As a result, because no allegations existed that JHP performed defective work on the interior portions of the condominiums, the damage to such property was not excluded from coverage under J(6). Rather, only the exterior finishes and retaining walls are "[t]hat particular part of any property that must be restored, repaired or replaced because [JHP's work] was incorrectly performed on it." *JHP*, 2009 WL 189886, slip op. at 14.

C. Fully Adversarial Proceeding

Having lost on the exclusions, Mid-Continent also argued that it should not be bound by the default judgment awarded against JHP in the underlying lawsuit because it did not constitute a "fully adversarial proceeding." In support of its position, Mid-Continent relied on *State Farm Fire and Casualty Co. v. Gandy*, 925 S.W.2d 696 (Tex. 1996), in which the Supreme Court of Texas invalidated an insured's assignment of his claims against his insurer. But, as correctly noted by the Fifth Circuit Court of Appeals, the Supreme Court recently clarified in *Evanston Insurance Co. v. ATOFINA Petrochemicals, Inc.*, 256 S.W.3d 660 (Tex. 2008), that "*Gandy's* holding was explicit and narrow, applying only to a specific set of assignments with special attributes" and that "[b]y its own terms, *Gandy's* invalidation applies only to cases that present its five unique elements." Because no assignment existed in *ATOFINA*, the Supreme Court's prior decision in *Employers Casualty Co. v. Block*, 744 S.W.2d 940 (Tex. 1988), applied. In *Block*, the Court held that an insurer who refuses to defend its insured when it has a duty to do so is bound by the amount of the judgment rendered against the insured.

Because the suit before the Fifth Circuit was not an action against defendant's insurer by plaintiff as defendant's assignee, *Gandy* was not implicated. Thus, *Block* controlled, and because Mid-Continent breached its duty to defend, it was bound by the default judgment awarded against its insured. *JHP*, 2009 WL 189886, slip op. at 15–16.

Commentary:

The Fifth Circuit's opinion in *JHP* is the latest in a growing line of cases in Texas where courts adhere to the plain language in the insurance policy while rejecting arguments about what the insurer *meant* to exclude. As a result, insureds continue to gain traction with respect to the proper interpretation of CGL policies for construction defect lawsuits. This decision is particularly significant in that it addresses the two main "course of construction" exclusions, which previously had been interpreted to broadly exclude property damage that occurred during construction.

While the Fifth Circuit's decision regarding J(5) is not earth-shattering, its analysis regarding the "that particular part" phrase in J(6) is extremely important. Insurers typically argue that the "that particular part" language—which is found in both J(5) and J(6)—is equivalent to the scope of the insured's contractual undertaking. Accordingly, for general contractors, the view was that any property damage to the project itself (i.e., the condominiums) that occurred during construction was excluded from coverage. And, since neither exclusion J(5) nor J(6) has a subcontractor exception like exclusion L, this broad interpretation oftentimes was fatal to coverage. The Fifth Circuit, however, correctly applied contract interpretation principles and limited the "that particular part" language such that it does not apply to otherwise non-defective work that is damaged during the course of construction—even if it is damaged as a result of the insured's defective work.

In addition, the court's adherence to the *Block* and *ATOFINA* line of cases also is significant. By holding Mid-Continent to the default judgment in this case, more insurers might now think twice before denying an insured a defense outright.

VII. *Pine Oak Builders, Inc. v. Great American Lloyds Insurance Co.*, No. 06-0867 (Tex. Feb. 13, 2009)

On February 13, 2009, the Supreme Court of Texas issued another important opinion for insurance law jurisprudence. *See Pine Oak Builders, Inc. v. Great Am. Lloyds Ins. Co.*, No. 06-0867 (Tex. Feb. 13, 2009). First, the Court applied its prior decision in *Lamar Homes, Inc. v. Mid-Continent Casualty Co.*, 242 S.W.3d 1 (Tex. 2007), finding that faulty workmanship claims can allege "property damage" caused by an "occurrence" and the Prompt Payment of Claims Act applies to an insurer's breach of its duty to defend its insured under a liability policy. Second, the Court also applied its recent decision in *Don's Building Supply, Inc. v. OneBeacon Insurance Co.*, 267 S.W.3d 20 (Tex. 2008), remanding the case to the trial court so that it can apply the actual-injury rule to determine whether the property damage claims fall within the insurers' policies. Third, and most importantly, the court addressed the ongoing debate regarding the use of extrinsic evidence to determine an insurer's duty to defend its insured. Again, the Court acknowledged its holding in *GuideOne Elite Insurance Co. v. Fielder Road Baptist Church*, 197 S.W.3d 305 (Tex. 2006), in which it rejected an exception for "overlapping" facts. It applied that same finding to the issues before it and found that extrinsic evidence could not be admitted and that Pine Oak Builders was not entitled to a defense from its insurer for the claims asserted against it by one of five separate plaintiffs.

A. The Background Facts

Pine Oak, a homebuilder, was insured by Great American under consecutive, occurrence-based commercial general liability insurance policies covering April 1993 to April 2001. Mid-Continent Casualty Co. issued similar policies from April 2001 to April 2003.

During a one-year period from February 2002 to March 2003, five homeowners sued Pine Oak in separate lawsuits, alleging that their homes suffered water damage as a result of defective construction. Four of the lawsuits claimed that the improper installation of an Exterior Insulation and Finish System ("EIFS") caused the damage, while the fifth lawsuit, the *Glass* lawsuit, alleged that the damage was caused by the improper construction of columns and a balcony.

Great American and Mid-Continent refused to defend Pine Oak, so Pine Oak filed a declaratory judgment action against them both. The insurers counterclaimed and all parties moved for summary judgment. Pine Oak urged a finding that it was entitled to a defense and damages. Great American argued that its policies did not cover the claims in the underlying lawsuits and Mid-Continent argued that its EIFS exclusion barred coverage. The trial court ruled in favor of the insurers on all the motions, and the court of appeals affirmed as to Mid-Continent because of the application of its EIFS exclusion. With regard to both insurers, the appellate court affirmed the trial court's ruling on the *Glass* lawsuit given the absence of any allegation that a subcontractor performed the work, but concluded that Great American owed a defense on each of the other four underlying lawsuits. The appellate court ruled that notwithstanding Great American's improper denial of defense, Pine Oak was not entitled to statutory damages.

B. *Lamar Homes* Applies

At the outset, the Supreme Court of Texas said that *Lamar Homes* foreclosed Great

American's argument that the faulty-workmanship claims asserted against Pine Oak did not constitute "property damage" caused by an "occurrence." *Id.* at 3. The Court said that the relevant language in Great American's policy was identical to that addressed in *Lamar Homes*. *Id.* In addition, the Court agreed with Pine Oaks that *Lamar Homes* also applied regarding the Prompt Payment of Claims Act. In particular, the Court found that the statute applies to Great American's breach of its duty to defend. *Id.* (citing *Lamar Homes*, 242 S.W.3d at 5, 20).

C. *Don's Building Supply* Applies

Turning to the issue of whether Great American's policies were triggered by the allegations in the underlying lawsuits, the Court noted that the houses at issue were built in 1996 and 1997—during Great American's time on the risk. The appellate court applied the "exposure rule" in finding that the Great American policies were potentially implicated and thus owed a defense. Great American, in turn, urged the Supreme Court to apply the "manifestation rule," which could have precluded coverage in its entirety.

Of course, as discussed earlier in this paper, the Court already had rejected both such trigger rules in its decision in *Don's Building Supply*, adopting instead an "actual injury rule." Under that rule, "property damage occurs during the policy period if 'actual physical damage to the property occurred' during the policy period." *Pine Oak*, slip op. at 4 (quoting *Don's Building Supply*, 267 S.W.3d at 24). The Court noted that the policy language before it in *Pine Oak* was identical to the language addressed in *Don's Building Supply*, and thus, the same rule applied. As such, the Court ordered the trial court to apply the "actual injury rule" on remand "to any remaining disputes about whether the property-damage claims fall within the terms of the Great American policies." *Id.* at 5.

D. *GuideOne*, Extrinsic Evidence and the "Eight Corners" Rule

The final issue addressed by the Court involved the admissibility of extrinsic evidence regarding the *Glass* lawsuit in order to establish Great American's duty to defend. *Id.* The importance of the evidence stemmed from exclusion (l) of the CGL policy, which excludes property damage to the insured's completed work unless "the damaged work or the work out of which the damages arises was performed on your behalf by a subcontractor." *Id.* Thus, coverage depends, at least in part, on whether the defective work was performed by Pine Oak or a subcontractor. *Id.* (citing *Lamar Homes*, 242 S.W.3d at 11).

In four of the underlying lawsuits, the homeowners specifically alleged that the defective work was performed by subcontractors, but the *Glass* lawsuit omitted any reference to defective work performed by a subcontractor. Rather, Pine Oak was alleged to have failed to perform its work in a good and workmanlike manner and failed to make requested repairs. *Id.* In Pine Oak's lawsuit against the insurers, the company submitted extrinsic evidence that the work at issue was performed by Pine Oak's subcontractors, and thus it contended that Great American had to defend the company in the *Glass* lawsuit. *Id.* at 6.

The Court acknowledged that the duty to defend is determined by the "eight corners" of the insurance policy and the underlying pleading. It noted that its decision in *GuideOne Elite Insurance Co. v. Fielder Road Baptist Church*, 197 S.W.3d 305 (Tex. 2006), had been issued six days before the appellate court's ruling in the Pine Oak

matter. In *GuideOne*, "[w]ithout recognizing an exception to the eight-corners rule, we held that any such exception would not extend to evidence that was relevant to both insurance coverage and the factual merits of the case alleged by the third-party plaintiff." *Pine Oak*, slip op. at 7 (quoting *GuideOne*, 197 S.W.3d at 309).

Applying that rule to the case before it, the Court found that Pine Oak's evidence contradicts the facts alleged in the *Glass* lawsuit. In particular, the plaintiffs in that case allege that Pine Oak constructed the columns and balcony at issue and that Pine Oak failed to perform its work in an good and workmanlike manner and failed to make repairs. *Id.* Such claims were barred from coverage by exclusion (l) of the CGL policy. Notably, "[f]aulty workmanship by a subcontractor that might fall under the subcontractor exception to the 'your work' exclusion is not mentioned in the petition." *Id.* "If the petition only alleges facts excluded by the policy, the insurer is not required to defend." *Id.* (quoting *Fid. & Guar. Ins. Underwriters, Inc. v. McManus*, 633 S.W.2d 787, 788 (Tex. 1982)).

Nevertheless, Pine Oak urged that the petition could be read to find that the culpable party in the *Glass* lawsuit was either Pine Oak or a subcontractor. Again, the Court disagreed. The petition in the *Glass* lawsuit, in contrast to the other four cases, did not allege faulty work by a subcontractor, did not allege that Pine Oak was liable for any subcontractor's work and did not allege negligent supervision of a subcontractor. *Id.* at 8. Rather, the petition alleged that Pine Oak—and only Pine Oak—was liable for its own actionable conduct. *Id.* The Court said that in "deciding the duty to defend, the court should not consider extrinsic evidence from either the insurer or the insured that contradicts the allegations of the underlying petition." *Id.* Because Pine Oak's evidence would have changed the allegations of the underlying lawsuit, it was inadmissible. "The policy imposes no duty to defend a claim that might have been alleged but was not, or a claim that more closely tracks the true factual circumstances surrounding the third-party claimant's injuries but which, for whatever reason, has not been asserted." *Id.* at 9. Because the duty to defend does not extend to allegations—true or false—that have not been made, Great American's duty to defend was not triggered by the *Glass* lawsuit. *Id.* at 10.

In finding that Great American did not owe a defense in that underlying lawsuit, the Court affirmed the appellate court's opinion. The appellate court had ruled that because no duty to defend existed, Great American also was not obligated to indemnify Pine Oak. Thus, in essence, the Court affirmed the holding that "no duty to defend means no duty to indemnify."

E. Different Case, Same Result

On the same day *Pine Oak* was decided, the Supreme Court of Texas also denied the petition in *D.R. Horton—Texas, Ltd. v. Markel International Insurance Company, Ltd.*, No. 06-1018 (Tex. Feb. 13, 2009). In that case, similar facts existed in that D.R. Horton was alleged to have performed faulty work related to masonry on a home that it built. *See D.R. Horton—Texas, Ltd. v. Markel Int'l Ins. Co., Ltd.*, 2006 WL 3040756 (Tex. App.—Houston [14th Dist.] Oct. 26, 2006), pet. denied). The masonry work was completed by a subcontractor, but the subcontractor was not mentioned at all in the pleadings in the underlying lawsuit. The appellate court adhered to the "eight corners" rule and refused to admit D.R. Horton's extrinsic evidence that would have entitled it to coverage as an additional insured under its subcontractor's policy. *Id.* at *5. Thus, the court of appeals ruled that

no duty to defend existed. In addition, just like the appellate court in *Pine Oak*, the court of appeals in *D.R. Horton* held that a finding of no duty to defend necessarily means that no duty to indemnify ever can exist. *Id.* at *6.

Commentary:

The Supreme Court of Texas' decision in *Pine Oak* is another monumental case with significant ramifications. Importantly, while the Court once again failed to recognize any exception to the "eight corners" rule, it did not necessarily foreclose the adoption of a limited exception for "coverage only" facts. Rather, it merely found a way to bar the evidence presented by Pine Oak, stating that it would contradict the allegations of the facts pleaded by the plaintiff in the underlying lawsuit.

Presumably, the Court may still recognize a limited exception for "coverage only" facts. Take the following scenario: A homebuilder like Pine Oak or D.R. Horton could be sued by a homeowner, who alleges that faulty work was performed by the homebuilder ***and*** its subcontractor, but the homeowner does not specifically name the subcontractor at issue. In that case, introduction of extrinsic evidence in order to supply the name of the subcontractor at issue should constitute "coverage only" evidence that does not contradict the allegations asserted or overlap with the liability facts. Instead, the evidence would merely replace the general term "subcontractor" with the specific names of such subcontractor. A similar situation has occurred in the past and been found acceptable. *See Int'l Serv. Ins. Co. v. Boll*, 392 S.W.2d 158 (Tex. Civ. App.—1965, writ ref'd n.r.e.) (finding that the petitions filed against a father for an accident occurring while his son was driving the car did not trigger a duty to defend because the father's only son was Roy Hamilton Boll, who specifically was excluded from coverage, even though Roy was not mentioned in the pleadings at issue). Provided that the homebuilder seeks to introduce the evidence in order to trigger coverage—as opposed to defeat its liability to the homeowner—the evidence should be allowed as "coverage only" evidence.

The most disturbing aspect of the Court's opinion in *Pine Oak* and its denial of petition in *D.R. Horton* is the ruling that no duty to defend necessarily means no duty to indemnify. In this author's opinion, such a ruling simply is wrong. In both cases, the actual facts established that the defective work at issue was performed by a subcontractor. The duty to indemnify, in contrast to the duty to defend, is based on the *actual* facts. Accordingly, even if the Court adheres to a strict eight corners approach for determining the duty to defend, nothing should have prevented Pine Oak or D.R. Horton from using the extrinsic evidence to establish a duty to indemnify.

The Court's ruling, despite lip service to the contrary, conflates the duty to defend and the duty to indemnify. A better stated rule would be: When no duty to defend exists, and no facts can be developed at the trial of the underlying lawsuit to impose coverage, an insurer's duty to indemnify may be determined by summary judgment at the same time as the duty to defend. In effect, the Court's ruling in *Pine Oak* and its denial of petition in *D.R. Horton* places too much emphasis on the oft-recognized principle that the duty to defend is broader than the duty to indemnify. While that principle is true in most cases, it *does not* hold true in every case. Both *Pine Oak* and *D.R. Horton* are perfect examples of where a strict adherence to an "eight corners" rule defeated a duty to indemnify even though extrinsic evidence would have established coverage.