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Demystifying CGL Coverage for Residential Defective Construction Claims

Over the past several years, an increasing number of opinions have been issued by appellate courts in Texas and across the country addressing CGL coverage for residential defective construction claims. Interestingly, although the modern CGL policy is broader than its predecessor versions, insurers have been more aggressive about denying coverage for these claims. In taking their aggressive stance, insurers often ignore the very policy language that forms the basis of the insurance contract. More specifically, rather than focus on the actual language of the CGL policy, insurers resort to traditional "business risk" arguments that have little, if any, connection with the modern CGL policy.

Similarly, even when insurers purport to analyze the actual policy language, their main focus of late has been on the insuring agreement (*e.g.*, the "property damage" and "occurrence" requirements) rather than on the construction-specific exclusions that were designed to establish the scope of coverage afforded for construction-related damages. In undertaking this myopic analysis of the CGL policy, insurers (and sometimes courts) ignore the fact that the construction-specific exclusions would be rendered mere surplusage if defective construction claims automatically ran afoul of the policy's insuring agreement.

The purpose of this article is to demystify CGL coverage for residential defective construction claims and, in the process, debunk many of the coverage positions taken by CGL insurers. In particular, this article will focus on the policy language as a whole and apply such language to a hypothetical, yet very typical, fact pattern involving a claim asserted by a homeowner against his builder and the subsequent denial of coverage by the builder's CGL carrier.

I. THE HYPOTHETICAL

Bob and Brenda Buyer ("Buyer") decided to build their dream home after winning several million dollars in the Texas lottery. The Buyers hired ABC Custom Homes, Inc. ("ABC") to build their dream home. ABC, in turn, subcontracted with various different contractors for the actual construction of the home. ABC contracted with Windows, Inc. to furnish and install windows throughout the home. ABC also contracted with Exteriors-R-Us, Inc. for the exterior cladding and flashing. Construction took place from January 2002 to November 2002. The pre-closing inspection took place in December 2002. During the inspection, certain minor defects were noticed and a punch list was created. The closing took place in January 2003 after the punch list was completed to the Buyer's satisfaction.

In March 2003, after a particularly bad rainstorm, the Buyers noticed several areas of the home that had leaked like a sieve. In particular, the Buyers noticed that water had intruded through many of the windows and at certain doors. The Buyers also noticed that the sheetrock on the walls and ceiling appeared wet in several places. The Buyers, who were very busy spending their lottery winnings, cleaned up the water and went about their business without reporting the claim to ABC. A month later, after another heavy rainfall, the Buyers noticed the same sort of water intrusion. Having lost a considerable amount of their winnings as a result of a day-trading fiasco, the Buyers decided that it would be prudent to contact an attorney to address the water intrusion problem.

The attorney retained an expert to inspect the Buyer's dream home. The expert discovered that the walls and ceiling

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were in fact damaged by water intrusion. In particular, the house had experienced a significant amount of wood rot as a result of the water intrusion due to a lack of flashing and improper installation of the windows. In addition, the expert discovered that the home was missing a vapor barrier. In addition to the wood rot, the expert noted some areas of mold growth behind the walls. An indoor air quality test confirmed the presence of mold in select portions of the home. Shortly thereafter, the Buyer's attorney sent a demand letter to ABC pursuant to the Residential Construction Liability Act ("RCLA"). ABC tendered the RCLA demand to its CGL insurer, Great Continent Insurance Company ("Great Continent"). Great Continent provided CGL coverage to ABC from November 2002 until November 2003. Prior to that point, ABC was insured by Mid-American Insurance Company ("Mid-American").[1] ABC did not tender the RCLA demand to Mid-American.

Great Continent responded to the RCLA tender with a letter to ABC stating that they were actively investigating the claim, but noted that CGL policies are not performance bonds and thus do not typically respond to these sorts of residential defective construction claims. Even so, the Great Continent letter warned ABC that it should take affirmative steps to mitigate any potential loss under the policy. The Great Continent letter also contained a builder's questionnaire for ABC to complete and promptly return.

Ultimately, after an agreement as to the proper scope of repairs could not be reached, a lawsuit was filed by the Buyers. The lawsuit alleged claims against ABC for: (i) negligence and negligent supervision; (ii) breach of contract; (iii) breach of express and implied warranties; (iv) negligent misrepresentation; (v) DTPA violations; and (vi) violations of the RCLA. The allegations, in a nutshell, were that ABC failed to construct the home in a good and workmanlike manner and that, as a result, the home experienced water and mold damage. Although the petition alleged that ABC failed to properly supervise the work of its subcontractors, the Buyers did not actually name the subcontractors as defendants. The petition also contained allegations that various parts of the home – especially around the windows and doors – were rotting away and that the problem was becoming worse with each rainfall. As a result, the Buyers alleged that they were forced to move out of their home and, in doing so, had to abandon some of their personal contents. Even so, the allegations of physical damage were restricted to the home itself without any mention of damages to personal property.

ABC immediately tendered the claim to Great Continent and requested a defense and indemnity. After several weeks went by, ABC received a declination letter from Great Continent. The declination letter provided the following reasons for the denial of coverage:

- The alleged construction defects are nothing more than business risks within the control of ABC; accordingly, any liability flowing from such business risks are contractual in nature to be remedied by way of a performance bond rather than a CGL policy;

- The construction of a house is an intentional and/or volitional act and thus any negative consequences flowing from such acts would violate the "occurrence" requirement and/or "expected or intended injury" exclusion;

- Claims for breach of warranty, breach of contract, misrepresentation, DTPA violations and RCLA violations likewise run afoul of the "occurrence" requirement and/or "expected or intended injury" exclusion;

- The allegations in the petition do not constitute "property damage" caused by an "occurrence" since the only alleged damage is to the home itself;

- Any damages may have preceded the policy period and thus ABC should put any prior carriers on notice;

- Even if "property damage" occurred during the policy period that was caused by an "occurrence," the allegations run afoul of: (i) exclusion a – "expected or intended injury" exclusion; (ii) exclusion j(5) – real property being worked on exclusion; (iii) exclusion j(6) – faulty workmanship exclusion; (iv) exclusion k – "your product" exclusion; (v) exclusion l – "your work" exclusion; (vi) exclusion m – "impaired property" exclusion; and (vii) exclusion n – "sistership" exclusion.

The letter concluded by requesting that ABC promptly tender any amended petitions for further consideration by Great Continent.

II. DUTY TO DEFEND, DUTY TO INDEMNIFY, AND CONTRACT INTERPRETATION PRINCIPLES

Before addressing the specific coverage issues raised by Great Continent's denial, it is important to set out the standards under Texas law on which insurers must base their coverage decisions. In particular, as with most states, Texas has different rules depending on whether the insurer is analyzing the duty to defend as contrasted with the duty to indemnify.

Likewise, Texas courts must follow certain contract interpretation principles in analyzing an insurance policy.

A. The Duty to Defend

Texas courts apply the "eight corners rule" to determine whether an insurer has the duty to defend its insured. *National Union Fire Ins. Co. v. Merchants Fast Motor Lines, Inc.*, 939 S.W.2d 139, 141 (Tex. 1997); *Pilgrim Enterprises, Inc. v. Maryland Cas. Co.*, 24 S.W.3d 488, 493 (Tex. App.-Houston [1st Dist.] 2000, no writ.). In undertaking the "eight corners" analysis, a court must compare the underlying plaintiff's allegations to the insurance policy without regard to the truth, falsity or veracity of the allegations. *See Argonaut Southwest Ins. Co. v. Maupin*, 500 S.W.2d 633, 635 (Tex. 1973); *Cullen/Frost Bank of Dallas, N.A. v. Commonwealth Lloyd's Ins. Co.*, 852 S.W.2d 252, 255 (Tex. App.–Dallas 1993, writ denied). In most circumstances, extrinsic evidence cannot be considered to determine the duty to defend. *See Westport Ins. Corp. v. Atchley, Russell, Waldrop & Hlavinka*, L.L.P., 267 F. Supp. 2d 601, 621-22 (E.D. Tex. 2003); *Tri-Coastal Contractors, Inc. v. Hartford Underwriters Ins.*, 981 S.W.2d 861, 863 (Tex. App.–Houston [1st Dist.] 1998, pet. denied).

Under the "eight corners rule," the allegations in the petition or complaint are given a "liberal interpretation." *See St. Paul Fire & Marine Ins. Co. v. Green Tree Financial Corp.*, 249 F.3d 389, 391 (5th Cir. 2001); *Merchants*, 939 S.W.2d at 141. Any doubts as to whether the petition states a covered cause of action must be resolved in the insured's favor. *See Harken Exploration Co. v. Sphere Drake Insurance*, 261 F.3d 466, 471 (5th Cir. 2001); *Adamo v. State Farm Lloyds Co.*, 853 S.W.2d 674, 676 (Tex. App.–Houston [14th Dist.] 1993, writ denied), *cert. denied*, 511 U.S. 1053 (1994). Moreover, even if the underlying plaintiff's allegations do not clearly show there is coverage, the insurer, as a general rule, will be obligated to defend if there is, potentially, an action alleged within the coverage of the policy. *See St. Paul Guardian Ins. Co. v. Centrum GS Ltd.*, 283 F.3d 709, 713 (5th Cir. 2002); *Merchants*, 939 S.W.2d at 141. Likewise, if the potential for coverage is found for any portion of a suit, the insurer must defend the entire suit. *See Green Tree Financial Corp.*, 249 F.3d at 395; *St. Paul Ins. Co. v. Tex. Dep't of Transp.*, 999 S.W.2d 881, 884 (Tex. App.–Austin 1999, pet. denied). Thus, alternative allegations of intentional and even malicious conduct will not defeat the duty to defend if combined with allegations that would otherwise trigger a potential for coverage. *See Harken*, 261 F.3d at 474; *Stumph v. Dallas Fire Ins. Co.*, 34 S.W.3d 722, 729 (Tex. App.–Austin 2000, no pet.).

B. The Duty to Indemnify

The duty to defend and the duty to indemnify are distinct and separate duties. *See Farmers Tex. County Mut. Ins. Co. v. Griffin*, 955 S.W.2d 81, 82 (Tex. 1997); *Trinity Universal Ins Co. v. Cowan*, 945 S.W.2d 819, 821-22 (Tex. 1997). In contrast to the duty to defend, the duty to indemnify is not based on the third party's allegations, but rather on the actual facts that comprise the third party's claim. *See Canutillo Indep. Sch. Dist. v. National Union Fire Ins. Co.*, 99 F.3d 695, 701 (5th Cir. 1996); *Cowan*, 945 S.W.2d at 821; *Great American Lloyds Ins. Co. v. Mittlestadt*, 2003 WL 21283175 (Tex. App.–Fort Worth June 5, 2003, no pet. h.). Accordingly, no duty to indemnify exists unless the underlying litigation establishes liability for damages covered by the CGL policy. *See Mittlestadt*, 2003 WL 21283175, at *2. Because the duty to defend is broader than the duty to indemnify, the insurer may have a duty to defend even when no duty to indemnify ultimately exists. *See Griffin*, 955 S.W.2d at 82.

The duty to indemnify is not ripe for determination prior to the resolution of the underlying defect claim *unless* the court first determines, based on the eight corners rule, that there is no duty to defend and the same reasons that negate the duty to defend also negate any potential for indemnity. *Griffin*, 955 S.W.2d at 82. Even if an insurer has extrinsic evidence that contravenes coverage-triggering allegations in a petition by demonstrating the applicability of a particular exclusion to coverage, that evidence can only be introduced at the duty to indemnify stage and may not be used to defeat the insurer's duty to defend. *See Westport Ins. Corp.*, 267 F. Supp. 2d at 622.

C. Contract Interpretation Principles

Insurance policies are contracts and are interpreted according to the same principles that govern contract interpretation. *See Balandran v. Safeco Ins. Co.*, 972 S.W.2d 738, 740 (Tex. 1998). The primary goal of contract interpretation is to "ascertain the intent of the parties as expressed in the instrument." *See State Farm Life Ins. Co. v. Beaston*, 907 S.W.2d 430, 433 (Tex. 1995). Moreover, in undertaking contract interpretation analysis, a court must read all parts of the instrument together in order to give meaning to every sentence and to avoid rendering any portion inoperative. *See id.*

"Under Texas law, the maxims of contract interpretation regarding insurance policies operate squarely in favor of the insured." *Lubbock County Hosp. Dist. v. National Union Fire Ins. Co.*, 143 F.3d 239, 242 (5th Cir. 1998). Accordingly, if a contract of insurance is susceptible to more than one reasonable interpretation, the court must adopt the construction most favorable to the insured. *See State Farm Fire & Cas. Co. v. Reed*, 873 S.W.2d 698, 699 (Tex. 1993); *Houston Petroleum Co. v. Highlands Ins. Co.*, 830 S.W.2d 153, 155 (Tex. App.–Houston [1st Dist.] 1990, writ denied). In fact, according to the Supreme Court of Texas, the insurance contract interpretation rules dictate that a court "must adopt the construction urged by the insured so long as that construction is not unrea-

sonable even if the construction urged by the insurer appears to be more reasonable or a more accurate reflection of the parties' intent." *Balandran*, 972 S.W.2d at 741.

III. DEBUNKING THE MYTH THAT CGL POLICIES NEVER COVER DEFECTIVE CONSTRUCTION CLAIMS

The overarching theme presented by most insurers is simply that CGL policies do not apply to allegations of defective construction. This argument fails to recognize the coverages afforded under *modern* CGL policies.[2] Likewise, it ignores well-settled contract interpretation principles that require insurers to give effect to the policy as a whole.

CGL policies are created with a modular structure under which the scope of coverage can be understood only by considering the policy as a whole. The insuring agreement grants broad coverage for "property damage" caused by an "occurrence" when the damage occurs during the policy period. The policy then narrows and defines the scope of coverage by shifting various identified risks back to the insured by way of specific exclusions. Notably, the CGL policy contains certain exclusions that remove *some* construction-related damages from the scope of coverage. The evolution of these policy exclusions demonstrates that insurers have *broadened* the scope of coverage afforded for construction-related damages. *See* Clifford J. Shapiro, *Further Reflections – Inadvertent Construction Defects are an "Occurrence" Under Commercial General Liability Policies*, COVERAGE (Nov./Dec. 2002) (hereinafter, Shapiro).

Recognizing that allegations of defective construction often do not fall squarely within any of the exclusions so as to negate the potential for coverage and thus the duty to defend, CGL insurers focus on the so-called business risk rationale and the insuring agreement to support their denials of coverage. The business risk rationale, in simple terms, stands for the proposition that defective construction is a business risk within the control of the contractor and thus is not covered by CGL policy.[3] The business risk rationale encompasses the argument that providing coverage for such risks would transform the CGL policy into a performance bond. Contrary to these arguments, most courts now recognize that the application of the so-called "business risk" rationale is specifically limited by the literal terms of the CGL policy.[4] *See Kvaerner Metals v. Commercial Union Ins. Co.*, 825 A.2d 641, 648-58 (Pa. 2003); *L-J, Inc. v. Bituminous Fire & Marine Ins. Co.*, 567 S.E.2d 489 (S.C. App. 2002); *Kalchthaler v. Keller Construction Co.*, 591 N.W.2d 169, 172-76 (Wis. App. 1999); *O'Shaughnessy v. Smuckler Corp.*, 543 N.W.2d 99, 102-05 (Minn. App. 1996).

Courts and commentators often point to the "subcontractor exception" language in exclusion l (a/k/a the "your work" exclusion or "business risk" exclusion) as specific evidence that the "business risk" rationale must be tempered by the literal policy language. In *Kalchthaler*, for example, the court noted as follows:

> For whatever reason, the industry chose to add the new exception to the business risk exclusion in 1986. We may not ignore that language when interpreting case law decided before and after the addition. To do so would render the new language superfluous. We realize that under our holding a general contractor who contracts all the work to subcontractors, remaining on the job in a merely supervisory capacity, can insure complete coverage for faulty workmanship. However, it is not our holding that creates this result: it is the addition of the new language to the policy. We have not made the policy close to a performance bond for general contractors, the insurance industry has. *Kalchthaler*, 591 N.W.2d at 174 (internal citations omitted).

The Minnesota Court of Appeals came to the exact same conclusion:

> Here, we are faced not with an omission, but an affirmative statement on the part of those who drafted the policy language, asserting that the exclusion does not apply to damages arising out of the work of a subcontractor. It would be willful and perverse for this court simply to ignore the exception that has now been added to the exclusion.
>
> We cannot conclude that the exception to exclusion (l) has no meaning or effect. The CGL policy already covers damage to the property of others. The exception to the exclusion, which addresses "'property damage' to 'your work,'" must therefore apply to damages to the insured's own work that arise out of the work of a subcontractor. *Thus, we conclude that the exception at issue was intended to narrow the Business Risk Doctrine. O'Shaughnessy*, 543 N.W.2d at 104-05 (emphasis added).

Texas courts, dating back to 1988, support this view as well:

> Under the more restrictive language of the endorsement, the insured is protected by the endorsement's completed operations coverage

> when the insured is legally liable for property damage to the work of the subcontractor, to the work of the insured or other subcontractors arising from the work of a subcontractor of the insured. In other words, although appellant would have no insurance coverage for damage to its work arising out of its work, appellant was covered for damage to its work arising out of a subcontractor's work. By contrast, absent the endorsement, under Exclusions (k) and (o), any property damage to work completed by appellant or on behalf of appellant by its subcontractors would be excluded. *Mid-United Contractors, Inc. v. Providence Lloyds Ins. Co.*, 754 S.W.2d 824, 827 (Tex. App.–Fort Worth 1988, writ denied) (discussing a predecessor version of exclusion l that was designed to broaden coverage over what was available in the 1973 CGL policy).

Applying the business risk rationale as espoused by CGL insurers would render the construction-specific exclusions mere surplusage and, in doing so, violate well-settled contract interpretation principles. *See King v. Dallas Fire Ins. Co.*, 85 S.W.3d 185, 193 (Tex. 2002) (warning against reading an insurance policy so as to render exclusions surplusage). Moreover, as noted, the business risk rationale finds support, for the most part, in case law that addresses predecessor versions of the CGL policy that contained narrower coverages. *See* Wielinski, at n.4. To put it simply, whether a particular defect claim is covered by a CGL policy should be answered by reading and applying the actual policy language – not by application of any sort of business risk rationale.[5]

IV. DEBUNKING THE DENIAL BASED ON THE POLICY LANGUAGE

Although it is often poor form for an author to give away the ending, the title of this section effectively gives the ending away. Suffice it to say, Great Continent's denial should not be sustainable under Texas law. This section of the article will analyze Great Continent's denial in light of the language in a modern CGL policy.

A. The Insuring Agreement

The insuring agreement of a CGL policy provides that the insurer agrees to 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. In addition, according to the insuring agreement, the "bodily injury" or "property damage" must be caused by an "occurrence" and must take place during the policy period.[6] Over the past several years, as evident from the increasing number of cases discussing the "occurrence" requirement in the defective construction context, insurers have focused far more on the insuring agreement than on the construction-specific exclusions.

Recently, a federal district court applying Texas law properly recognized that coverage for construction-related damages should be analyzed by way of the construction-specific exclusions and not by focusing on the insuring agreement:

> This court follows the [*Grapevine Excavation*] decision in the Fifth Circuit, as well as similar cases in other courts holding that construction defect claims arising from negligent work allege an "occurrence," leaving the coverage to be determined by construction-specific exclusions in the policy. *Great American Ins. Co. v. Calli Homes*, 236 F. Supp. 2d 693, 700 (S.D. Tex. 2002) (citing *Federated Mut. Ins. Co. v. Grapevine Excavation, Inc.*, 197 F.3d 720, 730 (5th Cir. 1999)); *accord Luxury Living, Inc. v. Continent Cas. Co.*, 2003 WL 22116202 (S. D. Tex. Sept. 10, 2003).[7]

It has become commonplace for CGL insurers, such as our hypothetical Great Continent, to largely ignore the construction-specific exclusions and instead focus almost exclusively on the insuring agreement as a basis to deny coverage. CGL insurers do so because the construction-specific exclusions often do not apply to negate coverage in its entirety. Moreover, the very presence of the construction-specific exclusions demonstrates the fallacy of relying on the insuring agreement to negate coverage for defective construction claims. Notably, no need would exist for the construction-specific exclusions if all construction-related damages automatically ran afoul of the CGL's insuring agreement.

1. The "Property Damage" Requirement

The term "property damage" is defined, in part, to mean "physical injury to tangible property, including all resulting loss of use of that property" and "loss of use of tangible property that is not physically injured." Thus, "property damage" may take either of two forms: (i) physical injury and consequential loss of use of the damaged property; or (ii) loss of use of tangible property that has not been physically injured. *See Travelers Indem. Co. v. Page & Associates Const. Co.*, 1998 WL 720957 (Tex. App. Amarillo Oct. 15, 1998, pet. denied). A claim only needs to satisfy one of the two prongs in order to satisfy the "property damage" requirement.

(a) Physical Injury to Tangible Property

The reference to "physical injury" within the definition of "property damage" suggests that there must be some form of

actual impairment or change to tangible property. Moreover, reference to "tangible property" is intended to preclude coverage for injury consisting solely of economic loss. Thus, a wall that is defective solely because it is not built according to specifications would not constitute "property damage." *See DCB Construction Co. v. Travelers Indem. Co.*, 225 F. Supp. 2d 1230, 1231 (D. Colo. 2002). In contrast, the "physical injury" requirement would be satisfied if the wall began to exhibit cracking or some other form of physical impairment. Likewise, when the insured misrepresents the pre-existing physical state of a home to a third party that subsequently buys it, the loss to the buyer is solely economic in nature. *See Freedman v. Cigna Ins. Co. of Texas*, 976 S.W.2d 776, 778 (Tex. App.–Houston [1st Dist.] 1998, no writ) (holding that misrepresentations related to the condition of a home did not constitute "property damage" caused by an "occurrence"); *State Farm Lloyds v. Kessler*, 932 S.W.2d 732, 737 (Tex. App.–Fort Worth 1996, writ denied) (same). In contrast, if the misrepresentation causes some action or inaction on the part of the third party that results in or contributes to the physical deterioration of the property, the "property damage" definition should be satisfied. *See Cyprus Amax Minerals Co. v. Lexington Ins. Co.*, 2003 WL 21373218 (Colo. June 16, 2003); *Sheets v. Brethren Mut. Ins. Co.*, 679 A.2d 540, 545-46 (Md. 1996); *see also* TURNER, CONSTRUCTION DISPUTES, at § 6:25.

The CGL policy does not cover purely economic losses (e.g., lost investment, loss of profits, etc.). *See, e.g., Houston Petroleum Co. v. Highlands Ins. Co.*, 830 S.W.2d 153 (Tex. App.–Houston [1st Dist.] 1990, writ denied). For example, the costs to investigate, test, diagnose, or mitigate work that is suspected of being defective would not, in and of themselves, qualify as "property damage" under a CGL policy. More specifically, absent covered "property damage," such costs would be considered purely economic losses. *See Houston Petroleum Co.*, 830 S.W.2d at 156; *see also Snug Harbor, Ltd. v. Zurich Ins.*, 968 F.2d 538 (5th Cir. 1992); *Hartzell Industries, Inc. v. Federal Ins. Co.*, 168 F. Supp. 2d 789, 802 (S.D. Ohio 2001). The fact that CGL policies do not cover *purely* economic losses does not mean, however, that economic losses are never covered. *See Amtrol, Inc. v. Tudor Ins. Co.*, 2002 WL 31194863 (D. Mass. Sept. 10, 2002).

To the contrary, a fact that is often overlooked by insurers is that CGL policies cover liability for "damages because of "property damage.'" The words "because of" in the insuring agreement indicate that all that matters is that the insured's legal liability have as its source, or arise from, physical injury to or loss of use of tangible property. Accordingly, once covered "property damage" has been established, the policy will cover economic losses that are incurred because of the "property damage." *See Riley Stoker Corp. v. Fidelity & Guar. Ins. Underwriters, Inc.* 26 F.3d 581 (5th Cir. 1994) (finding coverage for damages awarded for miscellaneous construction delays, such as scheduling and coordination delays as a consequence of covered "property damage"); *American Home Assurance Co. v. Libbey-Owens-Ford Co.*, 786 F.2d 22 (1st Cir. 1996); *Dimambro-Northend Associates v. United Construction, Inc.*, 397 N.W.2d 547 (Mich. App. 1986); *see also* DONALD S. MALECKI & ARTHUR L. FLITNER, COMMERCIAL GENERAL LIABILITY 8-9 (7th ed. 2001) (noting that once there is physical injury to tangible property, coverage should apply to any economic losses that flow as a consequence of such events."); ALLAN D. WINDT, INSURANCE CLAIMS & DISPUTES, REPRESENTATION OF THE INSURANCE COMPANIES AND INSUREDS, § 11:1, at p. 285 (4th Ed. 2001).

In addition to the purely economic loss issue, CGL insurers often contend that no "property damage" exists when the damage is to the insured's own work or product. Such a contention does not comport with the definition of "property damage." In particular, the definition *does not* state "physical injury to tangible property *of others*." Rather, it only requires that there be physical injury to tangible property.[8] Several Texas courts, *albeit* without specifically addressing the "property damage" issue, have found a duty to defend when the damage was to the home itself. *See, e.g., Luxury Living*, 2003 WL 22116202, at * 16; *Calli Homes, Inc.*, 236 F. Supp.2d at 700 (S.D. Tex. 2002);[9] *First Texas Homes, Inc. v. Mid-Continent Cas. Co.*, 2001 WL 238112 (N.D. Tex. Mar. 7, 2001), *aff'd*, ___ F.3d ___, 2002 WL 334705 (5th Cir. 2002); *CU Lloyd's of Texas v. Main Street Homes, Inc.*, 79 S.W.3d 687 (Tex. App.–Austin 2002, no pet.). Accordingly, while the fact that damage is restricted to the insured's work itself may be relevant to the application of certain construction-related exclusions, it should not affect the "property damage" analysis.

In our hypothetical, the Buyer's petition alleges damage in the form of wood rot caused by water intrusion.[10] The allegations of wood rot certainly constitute "physical injury to tangible property" so as to fall under the first prong of the "property damage" definition. Likewise, the growth of mold on certain parts of the home and the fact that the Buyers had to move out of their home as a result would satisfy the first prong of the "property damage" definition as well.

(b) Loss of Use of Tangible Property that has Not Been Physically Injured

The second prong of the "property damage" definition, which is independent of the first prong, provides that the "property damage" definition can be satisfied by demonstrating "loss of use of tangible property that has not been physically injured." A claim for loss of use must set forth damages because of a physical inability to use tangible property. *See, e.g., Gibson & Associates, Inc. v. Homes Ins. Co.*, 966 F. Supp.

468, 477 (N.D. Tex. 1997); *Travelers*, 1998 WL 720957. Although the second prong of the "property damage" definition is independent of the first prong, courts have taken a somewhat narrow view of the loss-of-use prong and often interpret the scope of coverage provided under it in tandem with an analysis of the business risk exclusions. *See AIU Ins. Co. v. Mallay Corp.*, 938 F. Supp. 407, 411-12 (S.D. Tex. 1996); *see also American Indem. Co. v. Iron City Lumber & Pallet, Inc.*, 2003 WL 724483 (Tenn. App. Mar. 4, 2003) (applying Texas law). When doing so, courts often improperly conclude that no "property damage" has been alleged simply because an exclusion applies to negate coverage. The "property damage" requirement, as well as the insuring agreement as a whole, should be analyzed independently of the application of any exclusions. In other words, the mere fact that an exclusion negates coverage does not necessarily mean that no "property damage" was alleged.

In our hypothetical, the loss of use of the undamaged personal property within the Buyer's home would constitute loss of use of tangible property that has not been physically injured. *See Travelers Indem. Co.*, 1998 WL 720957, at *5. Accordingly, in addition to the first prong, the second prong of the "property damage" also has been satisfied by the Buyer's lawsuit.

2. The "Occurrence" Requirement

The "occurrence" requirement is perhaps the single most often cited defense by CGL insurers in construction-related cases.[12] The term "occurrence" in a CGL policy "means an accident, including continuous or repeated exposure to substantially the same general harmful conditions." An "accident" includes damage that is the unexpected, unforeseen or undesigned happening or consequence of an insured's negligent behavior.[13] *See Massachusetts Bonding & Ins. Co. v. Orkin Exterminating Co.*, 416 S.W.2d 396, 400 (Tex. 1967). In particular, in one of the more recent cases on the "occurrence" requirement, the Supreme Court of Texas provided the following guidance:

> An injury caused by voluntary and intentional conduct is not an accident just because "the result or injury may have been unexpected, unforeseen and unintended." On the other hand, the mere fact that "an actor intended to engage in the conduct that gave rise to the injury" does not mean that the injury was not accidental. Rather, both the actor's intent and the reasonably foreseeable effect of his conduct bear on the determination of whether an occurrence is accidental. "[A]n effect that 'cannot be reasonably anticipated from the use of [the means that produced it], an effect which the actor did not intend to produce and which he cannot be charged with the design of producing, is produced by accidental means.'" *Mid-Century Ins. Co. of Texas v. Lindsey*, 997 S.W.2d 153, 155 (Tex. 1999).

Thus, according to the Supreme Court, two factors are considered in making the determination of whether a particular act or omission, or series of acts and omissions, constitutes an accident: (i) whether the actor intended to cause damage to others; and (ii) the reasonably foreseeable effect of the actor's intended conduct. *See id.*

Insurers typically contend that construction-related activities are intentional or volitional acts and that damages to the work itself that flow from such acts do not constitute "occurrences." Such a contention ignores the fact that a negligence allegation in a petition or complaint necessarily indicates that the injury-producing conduct in question could reasonably be foreseen to result in damages to a third party.[14] Thus, the very act that triggers liability would also preclude coverage under this analysis. *See* TURNER, CONSTRUCTION DISPUTES, at § 9:3. While it is beyond dispute that the construction of a home is an intentional or volitional act (*i.e.*, homes do not build themselves), that fact does not result in the conclusion that allegations of damage to the home run afoul of the "occurrence" requirement. In fact, the Supreme Court of Texas has expressly rejected the narrow view that all intentional or volitional acts run afoul of the "occurrence" requirement. *See Trinity Universal Life Ins. Co. v. Cowan*, 945 S.W.2d 819, 828 (Tex. 1997). In *Cowan*, the Supreme Court of Texas offered the illustration of a hunter who intentionally fires a gun believing his target to be a deer, when in fact it was a person. *See id.* The court reasoned that the adoption of the insurer's "occurrence" argument "would render insurance coverage illusory for many of the things for which insureds commonly purchase insurance." *Id.* at 828.

More recently, in *Harken*, the Fifth Circuit followed the Cowan rationale:

> if the act is deliberately taken, performed negligently, and the effect is not the intended or expected result had the deliberate act been performed non-negligently, there is an accident. *Harken Exploration Co. v. Sphere Drake Ins. PLC*, 261 F.3d 466, 472 (5th Cir. 2001) ("The operation of the oil facilities is the action deliberately taken, but alleged to have been performed negligently. The contaminated water, dead cattle, etc., caused by the pollutants, including saline substances, are the unintended and unexpected effects of the non-negligent operation of an oil facility.").[15]

Even more recently, the Austin Court of Appeals concluded that "if intentionally performed acts are not intended to cause harm but do so because of negligent *performance*, a duty to defend arises." *Main Street Homes*, 79 S.W.3d at 693 (emphasis in original); *see also Steve Roberts Custom Builders*, 215 F. Supp. 2d at 788-790 ("The focus should not be on whether the damage should have been expected when SRCB performed its duties negligently; rather the court should focus on the intended or expected results when SRCB performed those duties non-negligently."); *Hallman v. Allstate Ins. Co.*, 2003 WL 21751584 (Tex. App.– Dallas July 30, 2003, no pet.) ("Here, an occurrence is stated because the deliberately taken action, leasing Hallman's property, was allegedly performed negligently and the alleged damage to the neighbors' property and person was not the intended or expected result if the lease had been performed non-negligently.").

Similar to the argument set forth in the "property damage" section, insurers often argue that no "occurrence" has been alleged if the damage is to the insured's work itself. Once again, like with "property damage," a review of the "occurrence" definition does not reveal any requirement of damage to third party property.[16] In fact, at least one Texas court has rejected any such requirement:

> Mid-Continent attempts to distinguish *Grapevine Excavation* and its progeny by arguing that the damage alleged in this case was to a home designed and constructed by First Texas, not to work of a third party. The Court disagrees. When a third party's work is damaged, it "is presumed to have been unexpected and, therefore, constitutes an accident or an occurrence." *Grapevine Excavation*, 197 F.3d at 725. The paramount consideration for coverage purposes is whether the resulting damage was unexpected or unintended.
>
> * * *
>
> Thus, the relevant inquiry is not whether the insured damaged his own work, but whether the resulting injury or damage was unexpected or unintended. *First Texas Homes*, 2001 WL 238112, at *3.

Other Texas case law implicitly supports this view as well. *See, e.g., Luxury Living*, 2003 WL 22116202, at * 16 (finding a duty to defend a homebuilder even though the damage was to the home itself); *Calli Homes*, 236 F. Supp. 2d at 702 (same); *Main Street Homes*, 79 S.W.3d at 687 (same). Moreover, as will be discussed in greater detail in section IV.B.5., the "subcontractor exception" to exclusion l clearly signifies that the CGL policy contemplates covered damages to the work itself.[17]

The "occurrence" framework, as established by the case law cited above, boils down to a two-pronged test:

> **STEP 1:** Did the insured's conduct rise to the level of an intentional tort?
>
> • If "yes," then no "occurrence" exists regardless of whether the insured subjectively expected or intended the injury.
>
> • If "no," then proceed to step 2.
>
> **STEP 2:** Would the resulting "property damage" have been the natural or probable result had the insured acted in a non-negligent manner?
>
> • If "yes," then the conduct is not an "occurrence" even though the claims against the insured may be grounded in negligence.[18]
>
> • If "no," then the conduct constitutes an "occurrence."

The first prong of the test focuses on the insured's intent. Actions that rise to the level of an intentional tort are presumed not to be accidental and thus do not constitute an "occurrence." It should be noted that the mere insertion of the word negligence in a petition or complaint does not necessarily mean that an "occurrence" has been alleged. Rather, even at the duty to defend stage, the alleged conduct must be of the sort that actually sounds in negligence. An insured, for example, cannot claim that he negligently became intoxicated and thus is not responsible for his intentional conduct. *See Wessinger v. Fire Ins. Exchange*, 949 S.W.2d 834 (Tex. App.–Dallas 1997, no writ).[19] Similarly, even at the duty to indemnify stage, the mere finding of negligence may not result in coverage. *See In re Pierce Mortuary Colleges, Inc. v. Forrest*, 212 B.R. 549 (N.D. Tex. 1997) (noting that, despite a finding of negligence, none of the injuries would have occurred but for the insured's knowing and intentional conduct). Additionally, although often attempted by insurers, it is improper to impute a subcontractor's actions onto the homebuilder/general contractor for purposes of analyzing the "occurrence" requirement. Thus, even if the subcontractor's acts and/or omissions would not constitute an "occurrence," that fact should not alter the analysis as applied to the general contractor.[20]

The second prong focuses on the *reasonably* foreseeable effect of the insured's conduct.[21] The term "reasonably" is italicized because the second prong of the "occurrence" framework is analyzed on an objective basis. *See Wessinger*, 949 S.W.2d at 837. Thus, the insured's subjective intent should be irrelevant. *See id.* In fact, the insured's subjective intent to

cause injury should only be relevant in the context of the "expected or intended injury" exclusion. *See State Farm Fire & Cas. Co. v. S.S.*, 858 S.W.2d 374, 377 (Tex. 1993).

Applying this framework, or some variation of it, most courts that have considered the "occurrence" issue in the residential defective construction context have found in favor of the insured. *See Hartford Cas. Co. v. Cruse*, 938 F.2d 601, 604-05 (5th Cir. 1991) (concluding that extensive damage to a home caused by insured's defectively performed foundation leveling services was unexpected and unintended and, therefore, was caused by an "occurrence" within the meaning of the policy); *Luxury Living*, 2003 WL 22116202, at *16 (finding a duty to defend against allegations of defective construction); *Calli Homes*, 236 F. Supp. 2d at 702 (holding that Great American had a duty to defend its homebuilder insured against allegations of defective construction); *Steve Roberts Custom Builders*, 215 F. Supp.2d at 790 (holding that allegations that a homebuilder built a driveway that encroached on a neighboring lot was sufficient to trigger a duty to defend); *First Texas Homes*, 2001 WL 238112, at * 3 (holding that allegations of defective construction and misrepresentation against a homebuilder constituted an "occurrence" even when the damages were to the insured's own work); *E & R Rubalcava Const., Inc. v. Burlington Ins. Co.*, 147 F. Supp. 2d 523, 526 (N.D. Tex. 2000) (holding that allegations of defective construction constituted an "occurrence"); *McKinney Builders II, Ltd. v. Nationwide Mut. Ins. Co.*, 1999 WL 608851 (N.D. Tex. Aug. 11, 1999) (holding that allegations that a homebuilder built a house in the wrong spot constitutes an "occurrence"); *Main Street Homes*, 79 S.W.3d at 693-95 (holding that allegations of defective construction against a contractor constitutes an "occurrence"). Some courts, although in most cases for valid reasons, have found that the allegations against the homebuilder did not constitute an "occurrence." *See, e.g., Jim Johnson Homes, Inc. v. Mid-Continent Cas. Co.*, 244 F. Supp. 2d 706, 715-16 (N.D. Tex. 2003) (finding no coverage for various allegations, including defective construction, against a homebuilder); *Acceptance Ins. Co. v. Newport Classic Homes, Inc.*, 2001 WL 1478791 (N.D. Tex. Nov. 19, 2001) (finding no duty to defend a homebuilder against allegations of a builder's failure to comply with specifications); *Hartrick v. Great American Lloyds Ins. Co.*, 62 S.W.3d 270 (Tex. App.–Houston [1st Dist.] 2001, no pet.) (finding no duty to indemnify against a jury finding that the homebuilder breached an implied warranty); *Devoe v. Great American Ins. Co.*, 50 S.W.3d 567, 571-72 (Tex. App.—Austin 2001, no pet.) (finding no coverage for various allegations, including defective construction, against a homebuilder).[22]

The lawsuit in our hypothetical contains allegations of negligent conduct against ABC.[23] Further, no allegations exist that ABC intentionally substituted inferior building materials or that ABC intentionally constructed the home in a deficient manner.[24] Accordingly, plugging the facts of the lawsuit into the "occurrence" framework, it becomes even more clear that the Buyer's lawsuit alleges an "occurrence" — if the construction of the home (*i.e.*, the deliberate act) had been performed "non-negligently" (*i.e.* properly) the intended or expected result is a home that is built free of defects.[25] As a result, at least for purposes of the duty to defend, the Buyer's lawsuit satisfies the "occurrence" requirement.

3. Trigger of Coverage

The insuring agreement specifically requires that the "property damage" must take place during the policy period. Although this statement sounds simple enough, it has spawned numerous different "trigger" theories. While an in-depth analysis of the various trigger theories is beyond the scope of this article, it is important to clarify certain misconceptions that surround the triggering of a CGL policy. Most notably, homebuilders and other contractors often assume that the policy in place at the time of the alleged defective construction is the one that will be triggered. Typically, that is simply not the case.[26] Rather, although the Supreme Court of Texas has never adopted a particular trigger theory, the majority of cases that have addressed the issue in the "property damage" context hold that it is the policy in place at the time that the damage becomes readily apparent that is triggered.[27] *See American Home Assur. Co. v. Unitramp, Ltd.*, 146 F.3d 311, 313 (5th Cir. 1998); *Cullen/Frost Bank of Dallas, N.A. v. Commonwealth Lloyd's Ins. Co.*, 852 S.W.2d 252, 257 (Tex. App.–Dallas 1993, writ denied); *State Farm Mut. Auto. Ins. Co. v. Kelly*, 945 S.W.2d 905, 910 (Tex. App.–Austin 1997, writ denied) ("Texas courts have held that property loss occurs when the injury or damage is manifested."). *But see Pilgrim Enterprises, Inc. v. Maryland Cas. Co.*, 24 S.W.3d 488, 495 (Tex. App.–Houston [1st Dist.] 2000, no pet.) (adopting an exposure trigger in which all policies are triggered during the time in which exposure to the cause of the property damage occurred).

Although it is always dangerous to put a label on a particular trigger theory, the theory employed by most Texas courts is commonly known as the "manifestation" rule. In a nutshell, the manifestation rule provides that actual damage occurs when it becomes apparent or identifiable. Even so, damage does not automatically qualify as apparent or identifiable merely because it is "capable of being known by testing." *See Unitramp*, 146 F.3d at 313. In particular, an insured is not required or duty bound to "conduct limitless tests and inspections for hidden defects." *Id.* Instead, although it is a somewhat murky concept that is decided on a case-by-case basis, damage will be considered apparent and/or identifiable at the point when it is "capable of being perceived, recognized and understood." *Id.* at 314.

Many insurers incorrectly assume that only one policy can be triggered under a manifestation rule. In reality, although the manifestation rule often results in only a single triggered policy, several policies can be triggered when there are separate and distinct manifestations of "property damage." *See Cullen/Frost*, 852 S.W.2d at 257 ("In cases involving continuous or repeated exposure to a condition, there can be more than one manifestation of damage and, hence, an occurrence under more than one policy."); *see also Lisa Lewis & Jimmy L. Lewis v. State Farm Lloyds*, Civil Action No. G-02-246 (S.D. Jul 12, 2002) (slip op.) ("The Court does not need to decide when the *pre-existing* mold damage occurred, however, because new mold damage, arguably at least, occurred after the Policy went into effect.") (emphasis in original); *Encore Homes, Inc. v. Assurance Co. of Am.*, 2000 WL 798193 (N.D. Tex. June 21, 2000) ("Although Petroff bought her home in 1994, she alleges that '[a]dditional defects and problems with the home continue to arise on an almost daily basis' and that 'defects continue to become evident on almost a daily basis.' Given that the lawsuit was filed while the policy was still in effect, this allegation is sufficient to suggest that at least one occurrence became manifest during the policy period."). Accordingly, given that multiple manifestations may exist coupled with the fact that the Supreme Court has never adopted a particular trigger theory, insureds should be careful to tender the claim or lawsuit to all of the potentially triggered policies.[28]

In our hypothetical, assuming a manifestation rule applies, the Great Continent policy is triggered for purposes of the first prong of the "property damage" definition. In particular, although the construction took place during Mid-American's policy period, the physical damage to the home was first discovered in April 2003 when the home was inspected. Arguably, under a stricter version of the manifestation rule, the manifestation would have been deemed to occur in March 2003 when the Buyers first noticed (and ignored) the water intrusion. In either case, the "physical injury to tangible property" was discovered during the Great Continent policy period. It is possible, however, that the Mid-American policy also may be triggered. More specifically, the lawsuit alleges that the Buyers were forced to move out of their home and, in doing so, had to abandon some undamaged personal property. This allegation constitutes a "loss of use of tangible property that is not physically injured," which, per the policy language, is deemed to occur at the time of the occurrence that caused it. In this case, the alleged negligent construction from January 2002 to November 2002 was the occurrence that ultimately resulted in the loss of use. Accordingly, for purposes of the second prong of the "property damage" definition, Mid-American's policy period may also be triggered.

B. The Exclusions

Coverage for residential defective construction claims, in most cases, should be decided by analyzing the exclusions in the CGL policy. Seven exclusions are often raised as defenses in such claims. This section of the article will address the applicability (or inapplicability) of these exclusions as applied to our hypothetical. Prior to doing so, however, it is important to note that a CGL insurer bears the burden of proof with respect to the application of exclusions or other affirmative defenses to coverage. *See Pilgrim Enterprises*, 24 S.W.3d at 498; see also Tex. Ins. Code. Ann. Art. 21.58(b) (Vernon Supp. 2002) ("[t]he insurer has the burden of proof as to any avoidance or affirmative defense. . . .).

1. Exclusion a – The "Expected or Intended Injury" Exclusion

In addition to the "occurrence" requirement, standard CGL policies also contain an "expected or intended injury" exclusion. The exclusion eliminates coverage for "bodily injury" or "property damage" that is "expected or intended from the standpoint of the insured." The "expected or intended injury" analysis, although once part of the "occurrence" definition, is now a separate and distinct analysis. *See King*, 85 S.W.3d at 189. Notably, the "expected or intended injury" inquiry is more stringent than the "occurrence" inquiry since application of the exclusion requires proof that the insured *subjectively* desired the injury or damage.[29] *See Gulf Chemical & Metallurgical Corp. v. Associated Metals & Minerals Corp.*, 1 F.3d 365, 370 (5th Cir. 1993) (holding that the relevant question in applying "expected or intended" exclusion is whether the injury that forms the basis of the claim is expected or intended by the insured). In fact, intentional conduct that has unforeseen consequences will not trigger the exclusion. *See E&L Chipping Co. v. Hanover Ins. Co.*, 962 S.W.2d 272, 276 (Tex. App.-Beaumont 1998, no writ).

That the "expected or intended injury" exclusion focuses on an intent to injure as opposed to an intent to act is best illustrated by the Supreme Court's opinion in *State Farm Fire & Casualty Co. v. S.S.* In *S.S.*, the insured was sued by a former girlfriend for negligently inflicting her with genital herpes after engaging in consensual intercourse. The insured tendered the lawsuit to State Farm, his homeowners' insurer, who denied coverage based on the intentional injury exclusion. Coverage litigation ultimately ensued. The trial court ruled in favor of State Farm. The trial court's judgment was reversed by the court of appeals. On further appeal to the Supreme Court of Texas, State Farm set forth alternative arguments: (i) the insured acted intentionally; or (ii) intent to injure should be inferred as a matter of law. The Supreme Court, in a seminal opinion, disagreed:

> In this case, when the infected party is not experiencing any symptoms of the disease, transmitting herpes is not a *natural result* of engaging in sexual intercourse. Additionally, we are not determining whether the transmission of genital herpes was an "accident" or whether [the insured's] *acts* were intentional, but specifically whether [the insured] intentionally caused bodily injury to S.S. by transmitting herpes to her. This distinction is significant because the intentional injury exclusion provision states only that coverage does not exist for intentionally caused *bodily injury*, and does not state that coverage does not exist for intentional acts. *S.S.*, 858 S.W.2d at 377 n.2 (emphasis in original).

These principles were later followed by the Supreme Court in *Cowan*. Notably, in *Cowan*, the Supreme Court recognized that "accidental means" and "intentional injury" are not necessarily "opposite sides of the same coin." *Cowan*, 945 S.W.23d at 828. Indeed, cases certainly exist that fall outside of the scope of the "expected or intended injury" exclusion, but run afoul of the "occurrence" requirement. In *Pierce Mortuary*, for example, Judge Abramson noted that the "occurrence" analysis "varies from the rule generally used by Texas courts when deciding whether coverage is excluded by an intentional injury exclusion. In that type of case, the insured party's intent to cause the actual injury is the relevant inquiry." *In re Pierce Mortuary Colleges, Inc. v. Forrest*, 212 B.R. 549, 559 (N.D. Tex. 1997). Judge Abramson further concluded that although the acts and/or omissions of the insured violated the "occurrence" requirement, "[t]here is no clear evidence that the [insured] intended to cause the Judgment Creditors' injuries." *Id.* at 559 n.41.

The "expected or intended injury" exclusion, although heavily cited in reservation of rights and denial letters, should hardly ever be a factor in a defective construction case. In fact, attempts to invoke the exclusion in residential defective construction cases often fail. *See, e.g., Steve Roberts Custom Builders*, 215 F. Supp. 2d at 791. The reason is simple: contractors typically do not subjectively intend to cause property damage. In our hypothetical, at least at the duty to defend stage, the negligence allegations would negate application of the "expected or intended injury" exclusion.

2. Exclusion j(5) – "Real Property Being Worked On" Exclusion

The first construction-specific exclusion in the CGL policy is j(5). This exclusion eliminates coverage for "that particular part of real property on which you or any contractors or subcontractors working directly or indirectly on your behalf are performing operations, if the 'property damage' arises out of those operations." *See Jim Johnson Homes*, 244 F. Supp. 2d at 717 ("[T]he only property that the Jeters alleged was damaged is the property on which defendant was working pursuant to his contract with the Jeters. And, the damage alleged was caused by the work of the defendant or its subcontractors. Thus, exclusion J5 applies."); *Newport Classic Homes, Inc.*, 2001 WL 1478791, at *4 (N.D. Tex. Nov. 19, 2001) ("Because it is clear that the damage to the Taylors' home originated from Newport's (and its subcontractors') defective construction of the home, Exclusion J applies to the Taylors' claims against Newport and excludes them from coverage under the Policy); *see also Malone v. Scottsdale Ins. Co.*, 147 F. Supp.2d 623 (S.D. Tex. 2001); *Houston Bldg. Service, Inc. v. American General Fire & Cas. Co.*, 799 S.W.2d 308, 311 (Tex. App.–Houston [1st Dist.] 1990, writ denied).

The purpose of the exclusion is to exclude only "that particular part" of the real property on which work is being performed by or on behalf of the insured. The drafters' intention in including the "that particular part" language was to provide the same coverage to both general contractors and subcontractors for damages arising out of their operations by excluding only damage to the particular part of the property on which the insured or its subcontractors were working at the time of the damage.[30] Thus, despite the exclusion, coverage should exist for the repair, replacement, or restoration of non-defective work that is damaged as a result of defective construction. *See, e.g., Dorchester Development Corp. v. Safeco Ins. Co.*, 737 S.W.2d 380, 382 (Tex. App.–Dallas 1987, no writ). That being said, courts sometimes take an expansive view of "that particular part" so as to effectively broaden the scope of the exclusion beyond its intended application.

The use of the phrase "are performing operations" within the exclusion signifies that the exclusion is designed only to apply to course-of-construction damages. *See Luxury Living, Inc. v. Mid-Continent Cas. Co.*, 2003 WL 22116202, at * 17 (noting that exclusion j(5) could not apply because the underlying plaintiff first claimed damage to the home three years after its closing); *See Main Street Homes*, 79 S.W.3d at 695 ("Since the underlying petitions indicate that Main Street had completed construction and sold the homes to the home buyers *before* the alleged damage resulted, the exclusion does not preclude Lloyd's duty to defend Main Street); *see also American States Ins. Co. v. Powers*, 262 F. Supp. 2d 1245, 1251 (D. Kan. 2003) (holding that exclusion j(5) bars coverage only for damage involving works in progress); *Pinkerton & Laws, Inc. v. Royal Ins. Co. of Am.*, 227 F. Supp. 2d 1348, 1356 (N.D. Ga. 2002) (same); *Fisher v. American Family Mut. Ins. Co.*, 579 N.W.2d 599, 604 (N.D. 1998) (same); *Spears v. Smith*, 690 N.E.2d 557, 559 (Ohio App. 1996) (same). Under certain fact-specific scenarios, however, courts have concluded that exclu-

sion j(5) applies even though the work appeared complete at the time of the damage. *See, e.g., Malone*, 147 F. Supp. 2d at 629 n. 5 ("Because the Seventh Teste Petition alleges numerous failures to install key components of the foundation and fixtures, Malone's work could not be deemed 'complete.'").

Since exclusion j(5) only applies to damages that are discovered during the course of construction, it has no application to our hypothetical. In fact, given that a great majority of residential defective construction claims involve "property damage" that is discovered after the homeowner takes possession of the home, exclusion j(5) should not play a major role in analyzing coverage for residential defective construction claims.

3. Exclusion j(6) – "Faulty Workmanship" Exclusion

The second construction-specific exclusion is j(6), also known as the Faulty Workmanship Exclusion. It excludes coverage for "that particular part of any property that must be restored, repaired or replaced because 'your work' was incorrectly performed on it." "Your work" includes work performed by or on behalf of the insured. Accordingly, the exclusion negates coverage for defective work performed by the named insured or its subcontractors on both real or personal property. Like exclusion j(5), discussed above, exclusion j(6) contains the "that particular part" limitation. Thus, any damage to other property – including non-defective work of the insured or its subcontractors – should not be affected by the exclusion. *See E&R Rubalcava*, 147 F. Supp.2d at 528 (holding that exclusion j(6) only applies to the cost of repairing the defective work itself and not to any other damage to the homes at issue). Even so, as discussed in the preceding section, it is often difficult to pinpoint "that particular part" for purposes of applying the limiting language. *See Southwest Tank & Treater Manufacturing Co. v. Mid-Continent Cas. Co.*, 243 F. Supp. 2d 597, 604 (E.D. Tex. 2003) ("The entire tank was being worked on by Southwest. Under the factual situation in this case, the Court finds that the tank, in its entirety, or as a unit, is '[t]hat particular part of any property.'").

The language of exclusion j(6) goes on to state that it "does not apply to 'property damage' included in the 'products-completed operations hazard.'" Standard CGL policies define the "products-completed operations hazard" to include all property damage arising out of the insured's work-except "work that has not been completed or abandoned." As a result, like j(5), exclusion j(6) only applies to work that has not been completed or abandoned. *See Luxury Living*, 2003 WL 22116202, at *18 (holding that exclusion j(6) was inapplicable because the house had been completed and sold to the claimant prior to the claimed damage); *Main Street Homes*, 79 S.W.3d at 696-97 (same); *see also Hi-Port, Inc. v. American Intern. Specialty Lines Ins. Co.*, 22 F. Supp. 2d 596, 599 (S.D. Tex. 1997) (noting that exclusion j(6) only applies to work that was incomplete at the time of the damage).

Exclusion j(6) would not apply to our hypothetical since the damages were discovered after the Buyers took possession of their home. *See Main Street Homes*, 79 S.W.3d at 696-97 (holding that exclusion j(6) was inapplicable because the house had been completed and sold to the claimant prior to the claimed damage). Since a majority of claims against homebuilders involve completed operations, exclusion j(6) should not be a major obstacle to coverage.

4. Exclusion k – "Your Product" Exclusion

Exclusion k, the "your product" exclusion, eliminates CGL coverage for "property damage" to the insured's products arising from those products or any portion of them. The exclusion is intended to apply only to manufacturers and other entities that produce "products" rather than service companies such as contractors. *See* WIELINSKI, DEFECTIVE CONSTRUCTION, at p. 183.

This conclusion is bolstered by the fact that the definition of "your product" contains a clear exception for damage to "real property." A building or structure constructed by a contractor is real property and therefore would not qualify as a product for purposes of the exclusion. *See Mid-United Contractors*, 754 S.W.2d at 826; *see also Powers*, 262 F. Supp. 2d at 1252; *Prisco Serena Sturm Architects, Ltd. v. Liberty Mut. Ins. Co.*, 126 F.3d 886, 892 (7th Cir. 1997). Notably, as particularly relevant to our hypothetical, the Austin Court of Appeals has specifically concluded that homes constructed by a homebuilder were not "products" so as to fall within the scope of the "your product" exclusion. *See Main Street Homes*, 79 S.W.3d at 697. Consequently, little doubt exists that the "your product" exclusion would not apply to our hypothetical.

5. Exclusion l – "Your Work" Exclusion

Perhaps the most important exclusion for purposes of determining coverage for residential defect claims is exclusion l – the "your work" exclusion. The exclusion eliminates coverage for:

> *"Property damage" to "your work" arising out of it or any part of it and included in the "products-completed operations hazard."*
>
> *This exclusion does not apply if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor.*

In contrast to exclusions j(5) and j(6), which are course-of-construction exclusions, exclusion l only applies to completed operations. Work that may need service, maintenance, correction, repair or replacement, but which is otherwise complete, will be treated as complete for purposes of the products-completed operations hazard. Likewise, the insured's work is deemed completed when the insured has completed all of the work called for in the pertinent contract.

By its own terms, exclusion l eliminates coverage with respect to work that is both (i) performed by the named insured; and (ii) damaged by work performed by the named insured. *See* Robert J. Franco, *Insurance Coverage for Faulty Workmanship Claims Under Commercial General Liability Policies*, 30 TORT & INS. L. J. 785, 799 (Spring 1995); 4 BRUNER & O'CONNOR CONSTRUCTION LAW § 11:46 (May 2002). Absent both elements, the exclusion simply does not apply. Notably, the so-called "subcontractor exception" to the "your work" exclusion represents a major extension of coverage for defective construction that causes "property damage." The only damage that remains excluded after application of the exception is damage to the named insured contractor's work arising out of that work. Damage to subcontractor's work is covered (whether it arises out of the insured contractor's work or any subcontractor's work), as is damage to the insured contractor's work arising out of a subcontractor's work. *See* WIELINSKI, DEFECTIVE CONSTRUCTION, at p. 165; 4 BRUNER & O'CONNOR CONSTRUCTION LAW § 11:46 (May 2002). Thus, if the named insured becomes liable for damage to work performed by a subcontractor-or for damage to the named insured's own work arising out of a subcontractor's work-the exclusion does not apply to negate coverage. *See First Texas Homes*, 2001 WL 238112, at *4; *Luxury Living*, 2003 WL 22116202, at * 18; *Main Street Homes*, 79 S.W.3d at 697-98.

As outlined in section III. of this article, the inclusion of the "subcontractor exception" language is what courts and commentators often focus on to temper application of any bright line business risk rationale.[31] In particular, the "subcontractor exception" oftentimes grants back coverage for a majority of the damages that commonly exist in residential defective construction claims. In fact, whether a residential defective construction claim is covered under a CGL policy often will hinge on whether the damages constitute "course-of-construction" damages as opposed to "completed-operations" damages. The former is subject to the more stringent application of exclusions j(5) and j(6) whereas the latter is subject to exclusion l with its subcontractor exception. Because of this fact, insurers diligently try to circumvent the subcontractor exception language in exclusion l by focusing on the business risk rationale and/or on the insuring agreement in an attempt to negate coverage.

In our hypothetical, as in most cases involving home-builders or general contractors, the work out of which the damages arose was performed by subcontractors (*e.g.*, Windows, Inc. and Exteriors-R-Us). Accordingly, by operation of the explicit "subcontractor exception" language, the "your work" exclusion would not apply to negate coverage for ABC.[32]

6. Exclusion m - "Impaired Property" Exclusion

One of the most often cited and misunderstood exclusions is exclusion m, the "impaired property" exclusion, which negates coverage as follows:

> "Property damage" to "impaired property" or property that has not been physically injured, arising out of:
>
> (1) A defect, deficiency, inadequacy or dangerous condition in "your product" or in "your work"; or,
>
> (2) A delay or failure by you or anyone acting on your behalf to perform a contract or agreement in accordance with its terms.
>
> This exclusion does not apply to the loss of use of other property arising out of sudden and accidental physical injury to "your product" or "your work" after it has been put to its intended use.
>
> "Impaired property" means tangible property, other than "your product" or "your work," that cannot be used or is less useful because:
>
> a. It incorporates "your product" or "your work" that is known or thought to be defective, deficient, inadequate or dangerous; or
>
> b. You have failed to fulfill the terms of a contract or agreement;
>
> if such property can be restored to use by:
>
> a. The repair or replacement, adjustment or removal of "your product" or "your work" or
>
> b. Your fulfilling the terms of the contract or agreement.

The impaired property exclusion is designed to preclude "loss of use" coverage for business risks arising from the insured's failure to perform its contractual obligations. *See Pinkerton & Laws, Inc.*, 227 F. Supp. 2d at 1354. Stated differently, the exclusion bars coverage for "loss of use" claims

when: (i) the loss was caused by the insured's defective construction or faulty materials; and (ii) there has been no physical injury to property other than to the insured's work itself. *See American Mercury Ins. Group v. Urban*, 2001 WL 1723734 (D. Kan. May 23, 2001); *Standard Fire Ins. Co. v. Chester O'Donley & Associates, Inc.*, 972 S.W.2d 1, 10 (Tenn. App. 1998). The exclusion, by its own terms, does not apply if the insured's work cannot be repaired or replaced without causing physical injury to other property or if the "loss of use" of other property arises out of the sudden and accidental physical injury to the insured's work after it has been put to its intended use. *See Standard Fire Ins. Co.*, 972 S.W.2d at 10.

The "impaired property" exclusion is extremely difficult to apply. In fact, as one commentator notes, "there may be no less than 11 steps in the analysis of an impaired property claim ..." *See* WIELINSKI, DEFECTIVE CONSTRUCTION, at p.197. Perhaps this is why insurers have not had much success in relying on the impaired property exclusion to preclude coverage in defective construction claims under Texas law. *See Federated*, 197 F.3d at 727-28 (rejecting application of exclusion m); *Steve Roberts Custom Builders*, 215 F. Supp. 2d at 792-93 (same); *McKinney Builders*, 1999 WL 608851, at *9 (same). In particular, as applied to residential defective construction claims, the "impaired property" exclusion often does not apply because of one or more of the following reasons: (i) the exclusion is ambiguous; (ii) the exclusion does not apply when the work of third parties has been physically injured; or (iii) the damaged work does not constitute "impaired property" since "impaired property," by definition, must be something other than the insured's work.

Several cases, including at least one from Texas, support the ambiguity argument. *See McKinney Builders*, 1999 WL 608851, at *9 (concluding that the impaired property exclusion is ambiguous since its application turns on whether the alleged property damage is seen as damage to impaired property or damage as a result of physical injury to property); *see also Computer Corner, Inc. v. Fireman's Fund Ins. Co.*, 46 P.3d 1264, 1270 (N.M. App. 2002) ("Considering the difficulty this provision presents to this Court in its own effort to decode Fireman's policy, we conclude that this exclusion is unintelligible from the standpoint of a hypothetical reasonable insured..."); *Serigne v. Wildey*, 612 So.2d 155 (La. App. 1992) (holding that the impaired property exclusion is "hopelessly" ambiguous).

The fact that the exclusion does not apply to work that is physically injured is even more supportable. *See Steve Roberts Custom Builders*, 215 F. Supp. 2d at 792-93 (holding that exclusion m "is inapplicable to these allegations because physical injury to property was alleged"); *Gaylord Chemical Corp. v. Propump, Inc.*, 753 So.2d 349, 356 (La. App. 2000) (holding that the "impaired property" exclusion only excludes "damage to property that has not been physically injured or for which the claimed damages are only for loss of use of that property."); *Lang Tendons, Inc. v. Northern Ins. Co.*, 2001 WL 228920 (E.D. Pa. Mar. 7, 2001) (noting that the "impaired property" exclusion targets situation where a defective product, after being incorporated into the property of another, must be replaced or removed at great expense thereby causing loss of use of the property); *Standard Fire Ins. Co.*, 972 S.W.2d at 10 (same). Likewise, by its explicit terms, the "impaired property" exclusion only applies "if [the impaired property] can be restored to use by: a) the repair, replacement, adjustment or removal of '[the insured's] product' or ['the insured's] work'; or b) [the insured] fulfilling the terms of the contract or agreement." Thus, the exclusion has no application when work is damaged beyond repair. *See Dewitt Construction Inc. v. Charter Oak Fire Ins. Co.*, 307 F.3d 1127, 1134-35 (9th Cir. 2002).

The "impaired property" exclusion, as applied to our hypothetical, would not negate coverage in its entirety. In particular, the damaged home would not constitute "impaired property" since it is undoubtedly ABC's work. Further, the allegations against ABC go well beyond a pure loss of use claim. Likewise, it is quite possible that the repair would cause further physical injury or loss of use of the home. Aside from these arguments, the author believes that the "impaired property" exclusion is perhaps the most convoluted exclusion in the CGL policy and thus is a strong candidate for an ambiguity challenge as well. Even so, assuming the exclusion is not found to be ambiguous, it may apply to that portion of the Buyer's claim for loss of use of their undamaged contents. Notwithstanding this fact, since a potential for coverage still exists for other portions of the Buyer's claim, Great Continent would owe ABC a complete defense.

7. Exclusion n – "Sistership / Recall" Exclusion

Exclusion n, the "sistership" or "recall" exclusion, precludes coverage for damages incurred because of the recall, repair, replacement, or loss of use of the named insured's products. *See Gulf Ins. Co. v. Parker Products, Inc.*, 498 S.W.2d 676 (Tex. 1973); *Hi-Port*, 22 F. Supp. 2d at 601. Thus, the sistership exclusion is designed to shield insurers from liability for the costs associated with unanticipated product recalls. *See Gulf Ins.*, 498 S.W.2d at 679.

Although often cited by insurers in an attempt to exclude coverage for defective construction claims, it simply does not apply to defective construction claims. *See Standard Fire Ins. Co.*, 972 S.W.2d at 10 (refusing to apply the identical sistership exclusion to claims involving losses resulting from the failure of the insured's defective duct work or to claims that are not based on the withdrawal or recall of the insured's own product

or work); *see also Lang Tendons*, 2001 WL 228920 ("[i]t is well settled that this exclusion applies only if the product or property of which it is a part is withdrawn from the market or from use by the insured, and even in such situations, the policy still covers damages caused by the product that failed."); *Newark Ins. Co. v. Acupac Packaging, Inc.*, 746 A.2d 47, 56-57 (N.J. Super. 2000). Notably, the exclusion is limited to recalls of sister products and does not apply to claims involving "property damage" to the product or work that has already failed. *See Stonewall Ins. Co. v. Asbestos Claims Mgmt. Corp.*, 83 F.3d 610 (2d. Cir. 1995) (applying Texas and New York law); *Lafarge Corp. v. National Union Fire Ins. Co.*, 935 F. Supp. 675, 785 (D. Md. 1996) (applying Texas law); *Bright Wood Corp. v. Bankers Standard Ins. Co.*, 665 N.W.2d 544, 549 (Minn. App. 2003).

In our hypothetical, no sister products had been removed or withdrawn from the market. Likewise, the Buyers did not seek "withdrawal" or "recall" damages. *See Keystone Filler & Mfg. Co. v. American Mining Ins. Co.*, 179 F. Supp. 2d 432, 439 (M.D. Pa. 2002) ("If the damages claims have nothing to do with a withdrawal from the market or from use, the exclusion is inapplicable."); *Erie Ins. Exchange v. Colony Dev. Corp*, 736 N.E.2d 941, 949 (Ohio App. 1999) ("Here, there are no allegations in the Association's complaint indicating that anything-let alone the condominium units or any other condominium units designed and/or constructed by Colony-has been recalled or otherwise withdrawn from the market."). Thus, the sistership exclusion is wholly inapplicable.

V. CONCLUSION

The insurance coverage landscape in Texas has been marked by more and more residential defective construction claims. In particular, in recent years, insurers have focused on the insuring agreement and the so-called business risk rationale to support their denials of coverage. In doing so, insurers often ignore exclusions that are designed to delineate the scope of coverage for construction-related damages. An analysis of those exclusions, in many cases, reveals that they may not negate coverage for all of the claimed damages. Yet, despite this fact, the insured homebuilder often is faced with an improper denial of coverage.

In an attempt to demystify coverage for defective construction claims and, at the same time, debunk many of the arguments raised by insurers to deny coverage, this article analyzed the language of a CGL policy as applied to a very typical residential defective construction claim. The conclusion reached above is that the denial of ABC's claim was improper. Even so, analogous claims are routinely denied by CGL insurers for reasons that have little relation to the actual policy language. In the author's view, such denials are oftentimes improper. In particular, despite rhetoric to the contrary, CGL policies do in fact provide coverage for defective construction claims in many circumstances.

1. Great Continent and Mid-American are fictitious insurance companies. Any similarity to actual insurance companies is purely coincidental. The author also assures all of the readers that his fingers are not crossed behind his back.

2. In fact, to bolster their contention, CGL insurers often focus on case law that addresses earlier versions of the CGL policy. For example, many CGL insurers rely heavily on *T.C. Bateson Construction Co. v. Lumbermans Mut. Cas. Co.*, 784 S.W.2d 692, 694-95 (Tex. App.–Houston [14th Dist.] 1989, writ denied), which, in turn, relies on *Weedo v. Stone-E-Brick, Inc.*, 405 A.2d 788 (N.J. 1979). Likewise, CGL insurers oftentimes rely on *McCord, Condron & McDonald, Inc. v. Twin City Fire Ins. Co.*, 607 S.W.2d 956 (Tex. Civ. App. –Fort Worth 1980, writ ref'd n.r.e) as well as *Eulich v. Home Indem. Co.*, 503 S.W.2d 846 (Tex. Civ. App.–Dallas 1973, writ ref'd n.r.e). The courts in *T.C. Bateson, Weedo, McCord,* and *Eulich* construed exclusions in the 1973 version of the CGL policy in reaching their "no coverage" conclusions. The CGL policy has undergone significant changes since 1973 and thus the case law interpreting predecessor versions simply has little, if any, application to the modern CGL policy.

3. *See, e.g.*, Tinker, *Comprehensive General Liability Insurance–Perspective and Overview*, 25 F.I.C.C. 217, 224 (1975), in which the author sets forth the business risk rationale:

> It is not the function of the CGL policy to guaranty the technical competence and integrity of business management. The CGL policy does not serve as a performance bond, nor does it serve as a warranty of goods or services. It does not ordinarily contemplate coverage for losses which are a normal, frequent or predictable consequence of the business operations. Nor does it contemplate ordinary business expense, or injury and damage to others which results from intent or indifference... "Business risk," are those risks which management can and should control or reduce to manageable proportions; risks which management cannot effectively avoid because of the nature of the business operations; and risks which related to the repair or replacement of faulty work or products. These risks are a normal, foreseeable and expected incidence of doing business and should be reflected in the price of the product or service rather than as a cost of insurance to be shared by others.

4. For an excellent discussion of the history of the CGL policy, *see* Patrick J. Wielinski, *Full Circle Regression: The New ISO "Your Work" Endorsements* (January 2002) <http://www.irmi.com/expert/articles> (hereinafter, Wielinski); *see also* Shapiro, at p.6.

5. In a further rehash of the business risk rationale, CGL insurers often attempt to characterize the underlying plaintiff's claim as one that sounds in contract. In doing so, CGL insurers either ignore negligence allegations or argue that the economic loss rule bars the tort action. Even aside from the fact that the economic loss rule is a liability defense (as opposed to a coverage defense) and thus has no place in the duty to defend analysis, the characterization of a claim as sounding in contract as opposed to tort should not alter the coverage analysis. In particular, although some courts disagree, the CGL policy speaks in terms of "property damage" caused by an "occur-

rence" and does not address the contract vs. tort distinction. *See, e.g., Insurance Co. of N. Am. v. McCarthy Brothers, Co.*, 123 F. Supp. 2d 373, 377 (S.D. Tex. 2000) ("In Texas, the underlying liability facts, rather than the legal theory of liability, trigger the duty to indemnify."). Moreover, the argument that breach of contract allegations run afoul of the coverages afforded by a CGL policy creates a false dichotomy between "noncovered breach of contract" damages and "covered tort liability." *See generally* Jill B. Berkeley, *When A Breach of Contract Constitutes an Accident* (July 2000) <http://www.irmi.com/expert/articles>. Since the same act may constitute both a breach of contract and a tort, it is evident that such a distinction is without merit. *See, e.g., E&R Rubalcava Const., Inc. v. Burlington Ins. Co.*, 147 F. Supp. 2d 523, 527 (N.D. Tex. 2000) (noting that the breach of contract claims asserted against the insured were, in effect, claims of negligence); *see also Vandenberg v. Centennial Ins. Co.*, 982 P.2d 229 (Cal. 1999) (overruling a long line of cases standing for the no coverage for breach of contract rule).

6. The "legally obligated to pay as damages" language in the insuring agreement has created some recent controversy within the defective construction context. More specifically, as a variation to the argument that breach of contract allegations run afoul of the "occurrence" requirement, insurers often contend that the "legally obligated to pay as damages" language grants coverage only for tort-based liability as opposed to contract-based liability. According to this view, contractually mandated cost to repair defective construction would not be covered. Some courts have seemingly agreed with this view. *See, e.g., Data Specialties, Inc. v. Transcontinental Ins. Co.*, 125 F.3d 909 (5th Cir. 1997). Nothing in the express language of the insuring agreement, however, differentiates between tort-based and contract-based liability. *See* SCOTT C. TURNER, INSURANCE COVERAGE FOR CONSTRUCTION DISPUTES, § 6.8 (2d. ed. 1999) (hereinafter TURNER, CONSTRUCTION DISPUTES) ("Liability for breach of contract should qualify under the 'legally obligated' qualification of the insurance clause absent disqualification under some other term or provision of the policy. That is, the legal theory under which the claim against the insured is pursued, namely breach of contract, should have little or no relevance in the determination of coverage..."). Moreover, a recent opinion from the Fort Worth Court of Appeals recognizes that contract-based liability falls within the "legally obligated to pay as damages" language. *See Venture Encoding Service, Inc. v. Atlantic Mut. Ins. Co.*, 107 S.W.3d 729, 737 (Tex. App.–Fort Worth 2002, pet. filed); *see also Potomac Ins. Co. of Illinois v. Huang*, 2002 WL 418008 (D. Kan. Mar. 1, 2002); *Wanzek Construction, Inc. v. Employers Ins. of Wausau*, 667 N.W.2d 473, 477 (Minn. App. 2003) ("The [legally obligated to pay] language is broad and general enough to pertain to Wanzek's claim, which involves property damage and an apparent contractual obligation on Wanzek's part to repair or pay for the property damage.").

7. The fact that coverage for construction-related damages should be analyzed by way of the exclusions rather than the insuring agreement is not a new concept:

> [The insurance company] cites numerous cases for the general proposition that a policy is not a performance bond and, hence, does not cover claims for insufficient or defective work or the repair and replacement of that work. While this general proposition is true, the rationale for the proposition is not that the allegations of negligent construction or design practices do not fall within the broad grant for property damage caused by an occurrence, but that, as discussed in the balance of this opinion, the damages resulting from such practices usually are excluded from coverage by the standard exclusions found in such policies. *Erie Ins. Exchange v. Colony Development Corp.*, 736 N.E.2d 941, 949 (Ohio App. 1999).

8. Recently, a federal district court in Kansas expressly rejected the argument that "property damage" requires damage beyond the work itself. *See Fidelity & Deposit Co. v. Hartford Cas. Ins. Co.*, 189 F. Supp. 2d 1212, 1219-20 (D. Kan. 2002) ("The definition of property damage in the policies does not limit the coverage to property that is not in the possession of or work product of the insured. F&D correctly points out that if the work product of the insured could never come within the definition of property damage, then the exclusions set forth in the policy to limit such damages would be without meaning."). The Fidelity court applied the definition of "property damage" as written. Yet, despite the simplicity of the definition, many courts have improperly read in a requirement of third-party property damage. *See* Patrick J. Wielinski, *The Myth of "Third-Party" Property Damage*, (May 2003) http://www.irmi.com/expert/articles>.

9. Although the author acknowledges that the *Calli Homes* case involved allegations of "bodily injury" as well, it is clear from reading the opinion that Judge Rosenthal put no weight on that fact when analyzing coverage. Stated differently, it is clear that the holding would have been the same even had no "bodily injury" been alleged. *See, e.g., Luxury Living*, 2003 WL 22116202, at * 16.

10. The mere intrusion of water into a home, in and of itself, may not constitute "property damage." *See Amtrol*, 2002 WL 31194863 ("While Amtrol cites cases in which water damage in the form of rot or other damage to the home, its fixtures, and personal property is said to constitute property damage, no case holds that the simple presence of water, absent other manifestation of injury, amounts to physical damage.").

11. As will be discussed in section IV.B.6, this particular allegation may fall within the impaired property exclusion. Even if that is the case, however, the fact remains that the second prong of the "property damage" definition has been satisfied by the allegations in the Buyer's lawsuit.

12. This article focuses on the "occurrence" analysis as applied by Texas courts. For a more national perspective of the "occurrence" requirement in defective construction cases, see Linda B. Foster, *Point/Counterpoint: No Coverage Under The CGL Policy for Standard Construction Defect Claims*, 22 CONSTRUCTION LAWYER 18 (Spring 2002); Clifford J. Shapiro, *Point/Counterpoint: No Coverage Under The CGL Policy for Standard Construction Defect Claims*, 22 CONSTRUCTION LAWYER 13 (Spring 2002); PATRICK J. WIELINSKI, INSURANCE FOR DEFECTIVE CONSTRUCTION: BEYOND BROAD FORM PROPERTY DAMAGE COVERAGE Ch. 3 (IRMI 2000) (hereinafter WIELINSKI, DEFECTIVE CONSTRUCTION); TURNER, CONSTRUCTION DISPUTES, at § 6:46 .

13. One problem with applying the definition of "occurrence" is that the term "accident" is undefined. Dictionary definitions of "accident" demonstrate that the term refers to "an event which proceeds from an unknown cause, or is an unusual effect of a known cause, and therefore not expected" (WEBSTER'S NEW UNIVERSAL UNABRIDGED DICTIONARY, 2nd ed.) or "an unforeseen and unplanned event or circumstance; an unfortunate event resulting especially from carelessness or ignorance" (MERRIAM WEBSTER'S COLLEGIATE DICTIONARY, 10th ed.). Thus, as illustrated by the quoted definitions, a relationship exists between an effect and the cause of that effect. *See* JACK P. GIBSON & MAUREEN MCLENDON, COMMERCIAL LIABILITY INSURANCE § V (IRMI 1997 and Supp. 2002) (hereinafter GIBSON). A point that is often overlooked, however, is that nothing in the definition of an "occurrence" requires that an accident be something that happens for no reason. *See id.* Rather, "[e]very event has some precedent cause; identifying that cause does not necessarily deprive the event of its 'accidental' nature." *Id.*

14. In fact, a defendant cannot be held liable for negligence without evidence that the injury claimed by the plaintiff: (i) is the natural and probable result of the negligent act or omission in question; and (ii) that a person using ordinary care should have anticipated the danger created by the negligent act or omission. *See Doe v. Boys Clubs of Greater Dallas, Inc.*, 907 S.W.2d 472, 477-78 (Tex. 1995). The Dallas Court of Appeals, in an unpublished opinion, recognized that volitional and intentional acts do not necessarily run afoul of the "occurrence" requirement:

> On some level, all volitional acts are voluntary and intentional. Nonetheless, a person's acts may change from voluntary and intentional to involuntary and unintentional because of circumstances or facts of which the person is unaware. For example, if a man drives into an intersection, unaware that he has passed a stop sign requiring him to stop, and collides with another car, the collision is an accident. This is true regardless of the fact that the man voluntarily and intentionally drove into the intersection. The "act" that is the legal cause of the injuries is not the act of driving into the intersection, but the failure to stop at the stop sign. Because the driver was unaware of the stop sign, his failure to stop was not voluntary or intentional. *Atlantic Lloyd's Ins. Co. of Texas v. Scott Wetzel Services, Inc.*, 1997 WL 211537 (Tex. App.–Dallas Apr. 30, 1997, writ denied) (unpublished).

15. The *Harken* court recognized that two lines of "occurrence" cases exist in Texas: one for intentional tort cases (*i.e.*, the *Maupin* line) and one for negligence-based actions (*i.e.*, the *Orkin* line). *See Harken*, 261 F.3d at 472. Under the *Maupin* line for intentional torts, no "occurrence" exists regardless of whether the insured subjectively expected or intended the injury. *See id.* (citing *Argonaut Southwest Ins. Co. v. Maupin*, 500 S.W.2d 633 (Tex. 1973)). Under the *Orkin* line for negligence-based conduct, an "occurrence" exists even if the act is deliberate as long the damages were neither expected nor intended. *See id.* (citing *Massachusetts Bonding & Ins. Co. v. Orkin Exterminating Co.*, 416 S.W.2d 396 (Tex. 1967)). In cases involving mixed allegations, courts have consistently ruled that the *Orkin* line controls. *See id.* at 474; *Luxury Living*, 2003 WL 22116202, at *15; *Calli Homes*, 236 F. Supp. 2d at 700; *Mt. Hawley Ins. Co. v. Steve Roberts Custom Builders*, 215 F. Supp. 2d 783, 788 (E.D. Tex. 2002); *Main Street Homes*, 79 S.W.3d at 694.

16. An Ohio appellate court hit the nail on the head:

> The logical basis for the distinction between damage to the work itself (not caused by an occurrence) and damage to collateral property (caused by an occurrence) is less than clear. Both types of property damage are caused by the same thing – negligent or defective work. One type of damage is no more accidental than the other. Rather as evidenced by our original opinion, the basis for the distinction is not found in the definition of occurrence but by application of the standard "work performed" and "work product" exclusions found in the commercial general liability policy. *Erie Ins. Exchange v. Colony Development Corp.*, 736 N.E.2d 950, 952 (Ohio App. 1999).

The insurer's approach of requiring third-party property damage leads to absurd results. For example, most CGL insurers acknowledge that damage to personal property within a home constitutes an "occurrence" since it constitutes damage to third-party property. The act that led to the damage of the personal property, however, is the same act that caused the damage to the home itself. Yet, under the insurer's own reasoning, they would have a duty to defend the entire lawsuit.

17. The "subcontractor exception" to exclusion l grants back coverage for damages caused by the work of subcontractors. Since exclusion l applies only to "your [the named insured's] work," the "subcontractor exception" by necessity grants back coverage for the insured's own work. *See Kalchthaler*, 591 N.W.2d at 174; *O'Shaughnessy*, 543 N.W.2d at 104-05. Stated otherwise, since the CGL policy already covers damage to the property of others, the subcontractor exception to exclusion l must apply to damages to the insured's own work that arise out of the work of a subcontractor. *See O'Shaughnessy* 543 N.W.2d at 104-05.

18. *See, e.g., Meridian Oil Production v. Hartford Accident & Indemnity Co.*, 27 F.3d 150 (5th Cir. 1994) (holding that pollution "inevitably and predictably" resulted from the oil company's dumping of well wastes into open pits); *Martin Marietta Materials Southwest, Ltd. v. St. Paul Guardian Ins. Co.*, 145 F. Supp.2d 794, 799 (N.D. Tex. 2001) (court concluded that the "natural and predictable result of diverting or damming a river is a reduction of downstream waters, which could foreseeably harm downstream users even if performed in a non-negligent manner)."

19. The *Wessinger* court set out a slightly different variation of the two-pronged test:

> First, we determine the specific "acts" alleged to be the cause of the plaintiff's damages and then whether the acts were "voluntary and intentional." If we determine that the acts that produced the alleged injuries were committed involuntarily and unintentionally, our inquiry stops there because the results of the acts would be accidental. But if we determine the acts were committed voluntarily and intentionally, we must then decide under the [Maupin] definition whether the injuries were a "natural result" of the acts.
>
> When a result is not the natural and probable consequence of an act or course of action, it is produced by accidental means. The natural result of an act is the result that ordinarily follows, may be reasonably anticipated, and ought to be expected. This standard is objective. A person is held to intend the natural and probable results of his acts even if he did not subjectively intend to anticipate those consequences. *Wessinger*, 949 S.W.2d at 837.

20. In *King v. Dallas Fire Ins.*, 85 S.W.3d 185, 193 (Tex. 2002), the Supreme Court held that an insurer must defend an employer who is sued for derivative liability arising out of an employee's intentional conduct. Notably, in disapproving of a long line of cases that held to the contrary, the Court held that an employee's intentional conduct cannot be imputed to the employer for purposes of the "occurrence" analysis. *See King*, 85 S.W.3d at 191-92. The Supreme Court's analysis in *King* should apply with even greater force to the independent contractor relationship between a home-builder/general contractor and its subcontractor.

21. "In effect, the definition of 'occurrence' places the same requirement on the cause of the injury or damage that the 'expected or intended' exclusion place on the injury or damage itself. Each must be unintentional." Gibson, at §5. Interpreting the "occurrence" requirement as negating coverage for any intentional act would impermissibly render the exclusion for "expected or intended injury" surplusage. *See King*, 85 S.W.3d at 193.

22. These cases are addressed in greater detail in the Appendix to this article.

23. It is not necessary for the word accident or negligence to appear in the petition or complaint. *See Main Street Homes*,79 S.W.3d at 693. Likewise,

a determination on the ultimate issue of negligence need not be made in order to invoke the duty to defend. Rather, the underlying petition must simply allege facts for which a potential for coverage exists. *See Steve Roberts Custom Builders*, 215 F. Supp. 2d at 790.

24. Intentionally substituting inferior building materials, stealing from the construction account, misrepresenting pre-existing property damage, and walking off the job before it's complete are just some examples of intentional conduct that will often result, and properly so, in a finding of no "occurrence" even when the underlying plaintiff attempts to couch the allegations in terms of negligence. *See, e.g., Jim Johnson Homes*, 244 F. Supp. 2d 710-17; *Devoe*, 50 S.W.3d at 571-72.

25. In addition to the case law in the residential defective construction context, Texas courts have long held that allegations of defective construction constitute an "occurrence" as long as the damages were unexpected or undesigned from the standpoint of the insured. *See, e.g., Grapevine Excavation*, 197 F.3d at 725 (holding that allegations of defective construction constitute an "occurrence"); *Lafarge Corp. v. Hartford Cas. Ins. Co.*, 61 F.3d 389, 395 (5th Cir. 1995) (holding that unintended damage to a pipeline caused by the defective coating supplied by insured's subsidiary was caused by an "occurrence" within the meaning of the liability policy); *Insurance Co. of N. Am. v. McCarthy Bros. Co.*, 123 F. Supp. 2d 373, 377-78 (S.D. Tex. 2000) (holding that an insurer must indemnify its insured for its financial liability stemming from physical damage caused by the insured's negligence); *Employers Cas. Co. v. Brown-McKee, Inc.*, 430 S.W.2d 21, 24 (Tex. Civ. App.–Tyler 1968, writ ref'd n.r.e.) (holding that a manufacturer's alleged improper construction and repair of concrete grain storage elevator was an "accident" for the purposes of insurance coverage and defense because it brought about damage that was unexpected, unforeseen or undesigned).

26. One notable exception to this rule is when coverage is triggered by the second prong of the "property damage" definition. More specifically, "loss of use of tangible property that has not been physically injured" is deemed to occur at the time of the occurrence that caused the loss of use. In other words, the second prong of the "property damage" definition only requires that the loss of use be caused by an occurrence during the policy period – not that the loss of use occur during the policy period. *See, e.g., Travelers Indemn. Co.*, 1998 WL 720957.

27. In other contexts, such as bodily injury claims arising from exposure to asbestos, courts have adopted a broader exposure trigger theory. *See Guaranty Nat. Ins. Co. v. Azrock Industries, Inc.*, 211 F.3d 239, 244-52 (5th Cir. 2000).

28. The manifestation rule can have devastating effects for a homebuilder. For example, almost all policies issued to homebuilders since 2000 have had EIFS and mold exclusions. That was not the case prior to 2000. Accordingly, even if a home was built in 1996 when mold and EIFS exclusions were not in the policy, those exclusions may apply under a manifestation rule to a lawsuit brought for alleged defects in that home if the defects were first discovered after 2000.

29. Commentators and courts sometimes refer to the "expected or intended injury" exclusion as an "intentional acts" exclusion. Since the exclusion focuses on the subjective intent to injure, however, it is better characterized as an intentional injury exclusion.

30. The classic example used to explain the application of this exclusion is the erecting of steel beams. For example, let's assume that a steel beam collapses while it is being erected by a contractor. The beam that collapsed damages four other beams that were already in place. The exclusion, if properly applied, would exclude coverage only for the collapsing beam since it constitutes "that particular part" on which work was being performed at the time of the damage. *See* WIELINSKI, DEFECTIVE CONSTRUCTION, at n. 10.

31. The rationale for granting back coverage for claims arising out of a subcontractor's work is that a subcontractor's performance is not within the general contractor's effective control and thus presents an insurable risk rather than an uninsurable business risk. *See O'Shaughnesy*, 543 N.W.2d at 102-05; *L-J, Inc.*, 567 S.E.2d at 556-57 (noting that the contractor did not expect or intend that the pavement would fail given that the work was performed by its subcontractors).

32. Had the defective work in question been performed by employees of ABC rather than by subcontractors, the physical damages in our hypothetical would have been excluded from coverage by operation of the "your work" exclusion. Given this fact, as of 2002, certain insurers have eliminated the "subcontractor exception" language in any policy issued to a homebuilder. The elimination of the "subcontractor exception" language significantly narrows the coverage for homebuilders in relation to residential construction defect claims. In particular, absent the "subcontractor exception" language, coverage for a homebuilder would exist for completed operations only when the damage was to a third party's property (*e.g.*, the personal property of the claimant).