Lee H. Shidlofsky and Patrick J. Wielinski[1]

LAMAR HOMES V. MID-CONTINENT CASUALTY COMPANY: CERTIFYING THE CERTIFIABLE

I. Introduction

Modern construction is a dangerous business even though the means and methods of construction may have changed and improved over time. Many and varied risks are encountered and dealt with, whether through elimination or reduction through such means as safety planning, training and best practices. Others are transferred between the parties delivering the project or to third parties. The transfer of the majority of construction risks is usually supported by insurance, thus ultimately transferring potentially huge risks to a third party, an insurer considered to be more financially capable of bearing and spreading them.

The major means to insure property exposures on a construction site is through first party property insurance, that is, builders risk coverage. On the other hand, the major source of insurance protection for third party claims for any insured business, including owners, developers and contractors, is the commercial general liability (CGL) policy. In many instances, the line between builders risk and CGL coverage blurs, in that a CGL policy may provide coverage for a contractor for defective work, coverage which either coincides with, or is in excess of coverage provided under the builders risk policy. Due to the blurring between the property damage coverage under CGL policies and first party property insurance, exclusions relating to the work of contractors are included in CGL policies. This approach may work well with many types of insureds, but contractors and other service providers face property damage liability exposures that are not easily or cost-effectively covered under standard property or inland marine policies. These exposures lend themselves to coverage under liability insurance. For the most part, these types of exposures involve losses arising out of the unintentional acts of project participants, for example, where an electrician's faulty wiring may burn down an entire building.

Nowhere is the distinction between first party property coverage and liability coverage more blurred than in the area of defective work. Since builders risk policies, to a large extent, exclude coverage for defective work and design, owners, developers and contractors typically look to the CGL policy for coverage for this exposure. This exposure often dovetails with the insured's so-called "business risks," that is, those risks which are apparently under the control of the insured and which are, therefore, not regarded as fortuitous in nature. Understandably, insurers are hesitant to insure these types of risks, often finding it extremely difficult to distinguish between uninsurable business risks and accidental property damage covered under a CGL policy. These claims give insurers and insureds fits, and the insurance industry has struggled for decades to draft policy language to accomplish this goal.

These issues have played themselves out in the courts and particularly over the past few years, an increasing number of opinions have been issued by appellate courts and federal district courts sitting in Texas and across the country addressing CGL coverage for defective construction claims. Although the great majority of the case law purports to interpret standard policy language, the case law is decidedly split. Most of the focus, at least as of late, has been on the "property damage" and "occurrence" requirements in the insuring agreement as well as on attendant legal theories like the "business risk" rationale and/or the "economic loss" rule. In fact, oftentimes CGL insurers never raise or otherwise invoke any of the construction-specific exclusions that were designed to specifically set out the scope of coverage afforded by a CGL policy for construction defect claims. In undertaking this simplistic analysis of the CGL policy, insurers (and sometimes courts) ignore the fact that the construction-specific exclusions would serve no purpose if defective construction claims were found to automatically run afoul of the policy's "property damage" and "occurrence" requirements. Insurance policies simply are not written in such a fashion. Moreover, in failing to read and apply the policy as a whole, insurers deprive insureds of the coverage for which they paid and that is clearly contemplated by the CGL policy.

These issues are teed up before the Texas Supreme Court in *Lamar Homes v. Mid-Continent Casualty Company.* The case has attracted the attention of numerous amici curiae representing the interests of both insurers and insureds alike, with briefs filed well after submission. While it is difficult, if not impossible, to predict what the ultimate result of the case will be, it is the pur-

[1] Lee H. Shidlofsky is a partner in the Austin office of Nickens Keeton Lawless Farrell & Flack, LLP. His practice is devoted to representing corporate policyholders in insurance coverage matters with a particular emphasis on issues related to construction defect and product liability claims.

Patrick J. Wielinski is a principal in the Arlington office of Cokinos, Bosien & Young. He represents owners, general contractors, subcontractors and other participants in the construction industry in insurance coverage and risk management-related matters.

pose of this article to address and analyze the relative merits of the parties' arguments.

II. Factual Background

In April 1997, Vincent and Janice DiMare entered into a contract to purchase a home constructed by Lamar Homes. After completion, the DiMares allegedly discovered some physical damage to the stone veneer and sheetrock that was allegedly caused by defects in the design and/or construction of the foundation. In March 2003, the DiMares filed suit against Lamar Homes and its subcontractor claiming that Lamar Homes was negligent and failed to design and construct the foundation of the DiMares' residence in a good and workmanlike manner in accordance with implied and express warranties.

The DiMares alleged that defects in the foundation caused: (i) excessive deflection of the foundation; (ii) cracks in the sheetrock; (iii) cracks in the stone veneer; and (iv) binding and ghosting doors. In their petition, the DiMares alleged that an engineer retained by Lamar Homes prepared the foundation design, that another subcontractor poured the foundation, and that the engineer then inspected and approved the foundation at various points during construction. Lamar Homes, itself, did not design or construct the foundation. Instead, Lamar Homes relied on the expertise of an engineer and a foundation subcontractor. Yet, given the fact that Lamar Homes was in contractual privity with the DiMares, only Lamar Homes was sued for damages.

A. THE DISTRICT COURT CASE

Lamar Homes timely tendered the DiMare's lawsuit to Mid-Continent for defense and indemnity pursuant to the terms of the CGL policy. Mid-Continent, however, refused to defend Lamar Homes. More specifically, Mid-Continent relied on the following reasons to deny coverage: (i) the "economic loss" rule negates the DiMare's tort claims; (ii) a CGL policy distinguishes between tort liability and liability flowing from a breach of contract or breach of warranty; (iii) property damage to the home flowing from a breach of contract is inherently foreseeable and thus not an "occurrence" under a CGL policy; (iv) damages flowing from defective work in breach of a construction contract are necessarily an uninsured economic loss; (v) upholding coverage for property damage arising out of defective work transforms the CGL policy into a performance bond; and (vi) defective workmanship is an uninsurable business risk. Although some exclusions were mentioned in the denial letter, the focus of Mid-Continent's denial was clearly on the "property damage" and "occurrence" requirements in the CGL policy.

After receiving the denial, Lamar Homes filed suit against Mid-Continent. In response to Mid-Continent's defenses, Lamar Homes argued that: (i) the economic loss rule is a *liability* defense and has no effect whatsoever on the coverage determination under a CGL policy; (ii) nothing in a CGL policy's insuring agreement distinguishes between tort liability and contract/warranty liability; (iii) the use of foreseeability as the test for whether an "occurrence" has been alleged is inherently wrong and would result in illusory coverage; (iv) the policy language specifically provides coverage for damages that the insured becomes legally obligated to pay as damages because of "property damage," including economic losses that arise out of otherwise covered "property damage"; (v) while a performance bond and a CGL policy are undoubtedly different, they are not necessarily mutually exclusive when it comes to physical injury to tangible property; and (vi) the "business risk" rationale espoused by Mid-Continent is embodied in the CGL policy, at least to some extent, in the business risk *exclusions* and thus the focus should not be on the insuring agreement.

Lamar Homes and Mid-Continent filed cross-motions for summary judgment. The district court ruled in favor of Mid-Continent. Basically, even though the Underlying Lawsuit was still pending, the district court applied the economic loss rule and concluded that the DiMare's tort allegations were not viable. Then, the district court concluded that the remaining breach of contract and breach of warranty claims were an uninsurable business risk that ran afoul of the policy's "occurrence" and "property damage" requirements. More specifically, the district court reasoned that because the gravamen of the DiMare's lawsuit sought relief for a breach of contract resulting in pure economic loss, Mid-Continent was not obligated to provide a defense under the CGL policy. The district court further concluded that this result was mandated by *Jim Walter Homes, Inc. v. Reed*, 711 S.W.2d 617 (Tex. 1986). In so holding, the district court noted that "[t]he purpose of comprehensive liability insurance coverage for a builder is to protect the insured from liability resulting from property damage (or bodily injury) caused by the insured's product, but not for the replacement or repair of that product."[2]

B. THE FIFTH CIRCUIT APPEAL AND CERTIFICATION TO THE SUPREME COURT OF TEXAS

Lamar Homes appealed the district court's judgment to the Fifth Circuit. Shortly before oral argument, the Fifth Circuit certified three questions to the Supreme Court of Texas:

> (i) When a homebuyer sues his general contractor for construction defects and alleges only damage to or loss of use of the home itself, do such allegations allege an "accident" or "occurrence" sufficient to trigger the duty to defend or indemnify under a CGL policy?

[2] Lamar Homes v. Mid-Continent Cas. Co., 335 F. Supp. 2d 754, 759 (W.D. Tex. 2004).

(ii) When a homebuyer sues his general contractor for construction defects and alleges only damage to or loss of use of the home itself, do such allegations allege "property damage" sufficient to trigger the duty to defend or indemnify under a CGL policy?

(iii) If the answers to certified questions 1 and 2 are answered in the affirmative, does article 21.55 of the Texas Insurance Code apply to a CGL insurer's breach of the duty to defend?[3]

The Supreme Court accepted the certified questions. After additional briefing was filed, the Court heard oral arguments on February 14, 2006.[4] The remainder of this article will address the first two certified questions.

III. Duty To Defend, Duty To Indemnify, Contract Interpretation Principles And Burden Of Proof

Before addressing the specific coverage issues raised by *Lamar Homes*, it is important to set out the standards by which courts must interpret the policy contracts before them and upon which to 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 a lawsuit filed against its insured as contrasted with the duty to indemnify, that is, to pay a claim. Likewise, Texas courts must follow basic 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 a duty to defend its insured.[5] In undertaking the "eight corners" analysis, a court of appeals must compare the allegations in the live pleading to the insurance policy without regard to the truth, falsity, or veracity of the allegations.[6] Facts ascertained before suit, developed in the process of litigation, or determined by the ultimate outcome of the suit do not affect the duty to defend.[7] Thus, in most circumstances, extrinsic evidence cannot be considered to determine the duty to defend.[8] Under the "eight corners rule," the allegations in the pleadings are given a "liberal interpretation."[9] Any doubts must be resolved in favor of the insured.[10] 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.[11] Likewise, if the potential for coverage is found for any portion of a suit, the insurer must defend the entire suit.[12] Accordingly, 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.[13]

Finally, it is uniformly accepted that the duty to defend is broader than the duty to indemnify.[14] Accordingly, an insurer may have a duty to defend even when the adjudicated facts ultimately result in a finding that the insurer has no duty to indemnify.[15]

B. THE DUTY TO INDEMNIFY

It is well-settled that the duty to defend and the duty to indemnify are distinct and separate duties.[16] In contrast to the duty to defend, the duty to indemnify is not based on the third-party claimant's allegations, but rather upon the actual facts that comprise the third party's claim.[17] The duty to indemnify is not ripe for determination prior to the resolution of the underlying construction defect

[3] Lamar Homes v. Mid-Continent Cas. Co., 348 F.3d 193 (5th Cir. 2005).

[4] All of the briefing can be found at the Supreme Court's website at http://www.supreme.courts.state.tx.us/ebriefs/files/20050832.htm. In addition, a recording of the oral argument can be heard at http://www.supreme.courts.state.tx.us/oralarguments/audio_2005.asp.

[5] *See* Nat'l Union Fire Ins. Co. v. Merchants Fast Motor Lines, Inc., 939 S.W.2d 139, 141 (Tex. 1997); Northfield Ins. Co. v. Loving Home Care, Inc., 363 F.3d 523, 528-35 (5th Cir. 2004).

[6] *See* King v. Dallas Fire Ins. Co., 85 S.W.3d 185, 191 (Tex. 2002); *Northfield*, 363 F.3d at 528.

[7] *See* Trinity Universal Inc. Co. v. Cowan, 945 S.W.2d 819, 829 (Tex. 1997); *Northfield*, 363 F.3d at 528.

[8] *See* Guideone Elite Ins. Co. v. Fielder Road Baptist Church, 49 Tex.Sup.Ct.J. 877, ___S.W.3d ___, 2006 WL 1791689 (Tex. June 30, 2006).

[9] *See Merchants Fast Motor Lines, 939* S.W.2d at 141; Guar. Nat'l Ins. Co. v. Azrock Indus., 211 F.3d 239, 243 (5th Cir. 2000).

[10] *See Merchants Fast Motor Lines*, 939 S.W.2d at 141; Harken Exploration Co. v. Sphere Drake Ins. PLC, 261 F.3d 466, 474 (5th Cir. 2001).

[11] *See Merchants Fast Motor Lines*, 939 S.W.2d at 141; *Harken*, 261 F.3d at 471.

[12] *See* St. Paul Ins. Co. v. Tex. Dep't of Transp., 999 S.W.2d 881, 884 (Tex. App.—Austin 1999, pet. denied); *Northfield*, 363 F.3d at 528.

[13] *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.).

[14] *See* Burlington Ins. Co. v. Tex. Krishnas, Inc., 143 S.W.3d 226, 229 (Tex. App.-Eastland 2004, no pet.); E&L Chipping Co. v. Hanover Ins. Co., 962 S.W.2d 272, 274 (Tex. App.—Beaumont 1998, no writ); *Northfield*, 363 F.3d at 528.

[15] *See* Utica Nat'l Ins. Co. v. Am. Indem. Co., 141 S.W.3d 198, 203 (Tex. 2004); Farmers Tex. County Mut. Ins. Co. v. Griffin, 955 S.W.2d 81, 82 (Tex. 1997).

[16] *See Griffin*, 955 S.W.2d at 82; *Cowan*, 945 S.W.2d at 821-22.

[17] *See* Am. Alliance Ins. Co. v. Frito-Lay, Inc., 788 S.W.2d 152, 154 (Tex. App.—Dallas 1990, writ dism'd); Canutillo Indep. Sch. Dist. v. Nat'l Union Fire Ins. Co., 99 F.3d 695, 701 (5th Cir. 1996).

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.[18]

C. CONTRACT INTERPRETATION PRINCIPLES

Insurance policies are contracts and interpreted according to the same principles that govern contract interpretation.[19] The primary goal of contract interpretation is to "ascertain the intent of the parties as expressed in the instrument."[20] 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.[21]

"Under Texas law, the maxims of contract interpretation regarding insurance policies operate squarely in favor of the insured."[22] 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.[23] Moreover, the insurance contract interpretation rules dictate that a court "must adopt the construction urged by the insured so long as that construction is not unreasonable, even if the construction urged by the insurer appears to be more reasonable or a more accurate reflection of the parties' intent."[24]

D. BURDEN OF PROOF

An insured has the initial burden of demonstrating that a claim is potentially within the scope of coverage.[25] The burden then shifts to an insurer to prove that one of the exclusions, conditions, and/or limitations within the policy constitutes an avoidance or affirmative defense that defeats coverage in its entirety.[26] In particular, the Texas Insurance Code makes clear that an insurer must plead and prove, by a preponderance of the evidence, that an exclusion or other affirmative defense negates coverage.[27]

IV. THE CGL POLICY PROVIDES SPECIFIC COVERAGE FOR INADVERTENT CONSTRUCTION DEFECTS THAT RESULT IN PHYSICAL DAMAGE TO OR LOSS OF USE OF THE WORK ITSELF

Many insurers, particularly Mid-Continent and its related company, Great American Lloyds Insurance Company, deny defective construction claims based on the notion that the insuring agreement of a CGL policy, which is comprised of the "property damage" and "occurrence" requirements, does not apply to defective workmanship claims when the damage is to the work itself. It makes no difference, under this analysis, whether the defective work was performed by the general contractor or by a subcontractor. This view, however, fails to recognize the scope of coverage afforded under a *modern* CGL policy and, in particular, ignores the evolution of the CGL policy.

CGL policies are written on forms with a modular structure, under which, even though comprised of a number of parts, the scope of coverage can be understood only by considering the policy as a whole. Such policies begin with an insuring agreement that grants broad coverage for "property damage"[28] caused by an "occurrence."[29] The policy then narrows and defines the scope of coverage by shifting various identified risks back to the insured by way of specific exclusions. These exclusions, as applied to the construction industry, generally are

[18] *See Griffin*, 955 S.W.2d at 82.

[19] *See* Balandran v. Safeco Inc. Co., 972 S.W.2d 738, 740 (Tex. 1998).

[20] Nat'l Union Fire Ins. Co. v. CBI Indus., 907 S.W.2d 517, 520 (Tex. 1995).

[21] *See Id.; see also* State Farm Life Ins. Co. v. Beaston, 907 S.W.2d 430, 433 (Tex. 1994) (noting that "courts must be particularly wary of isolating from its surroundings or considering apart from other provisions a single phrase, sentence, or section of a[n insurance] contract").

[22] Lubbock County Hosp. Dist. v. Nat'l Union Fire Ins. Co., 143 F.3d 239, 242 (5th Cir. 1998).

[23] *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 den'd).

[24] *Balandran*, 972 S.W.2d at 741. Neither Lamar Homes nor Mid-Continent argued before the Supreme Court that the CGL policy was ambiguous. Even so, Lamar Homes set forth the contract interpretation principles and noted that two reasonable interpretations created an ambiguity to be construed in Lamar Homes' favor. Mid-Continent argued that the contra-insurer rule only applied to exclusions and thus could not apply to interpretation of the insuring agreement. Although the contra-insurer rule applies with even greater force to the application of exclusionary language, the rule is not limited to exclusions. Notwithstanding this fact, even if Mid-Continent was correct that the contra-insurer rule applies only to exclusions, it is abundantly clear that Mid-Continent treats the "property damage" and "occurrence" requirements as exclusions to coverage.

[25] *See Northfield*, 363 F.3d at 528.

[26] *See* TEX. INS. CODE ANN. art. 554.002 (previously 21.58(b)) ("The insurer has the burden of proof as to any avoidance or affirmative defense . . ."); *Northfield*, 363 F.3d at 528; *see also* Performance Autoplex II Ltd. v. Mid-Continent Cas. Co., 322 F.3d 847, 854 (5th Cir. 2003).

[27] *See* Nobles v. Employees Retirement Sys. of Tex., 53 S.W.3d 483, 486 (Tex.App.—Austin 2001, no pet.).

[28] "Property damage" is defined in the standard CGL policy, in pertinent part, as "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."

[29] "Occurrence" is defined in the standard CGL policy as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions."

referred to as the "business risk" exclusions.[30] Notably, the business risk exclusions remove *some* construction-related damages from the scope of coverage provided by the insuring agreement. These exclusions, in turn, have certain exceptions that preserve coverage for identified risks. One of those risks, as will be discussed in greater detail, is when the "damaged work or the work out of which the damage arises was performed on the [general contractor's] behalf by a subcontractor."[31]

The evolution of these policy exclusions and the exceptions to the exclusions demonstrates that insurers have *broadened* the scope of coverage provided to general contractors for completed operations and, in particular, that CGL insurers intended to provide coverage to general contractors when the allegedly defective work was performed on their behalf by subcontractors.[32] A federal district court applying Texas law correctly recognized that coverage for construction-related damages should therefore be analyzed by way of the construction-specific exclusions and not by misapplying the threshold definitions of "occurrence" and "property damage" within 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.[33]

The fact that coverage for construction-related damages should be analyzed by way of the construction-specific exclusions rather than the insuring agreement is not a novel 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 coverage for property damage caused by an occurrence, but that, as discussed in the balance of this opinion, the damages resulting from such practices are usually excluded from coverage by the standard exclusions found in such policies.[34]

These definitional coverage defenses ignore the construction-specific exclusions. A review of the policy, and in particular the "subcontractor exception" to exclusion L, however, demonstrates that none of the construction-specific exclusions negate coverage when an owner sues a general contractor for physical damage (or loss of use) to a completed construction project or home when the damaged work or the work out of which the damage arises was performed by a subcontractor.[35] Further, the very presence of the construction-specific exclusions demon-

[30] The most commonly applied business risk exclusions are: **J(5)** (the "operations" exclusion), **J(6)** (the "faulty workmanship" exclusion), **K** (the "your product" exclusion), **L** (the "your work" exclusion), **M** (the "impaired property" exclusion), and **N** (the "sistership/ product recall" exclusion).

[31] This language comes directly from the exception to Exclusion L, the "your work" exclusion, and its importance is discussed extensively later in this article.

[32] See Phillip L. Bruner & Patrick J. O'Connor, 4 Bruner & O'Connor on Construction Law Ch. 11 (1st ed. 2002) (updated 2005) (hereinafter, Bruner & O'Connor); Patrick J. Wielinski, Insurance for Defective Construction Chs. 11, 16 (2d ed. 2005) (hereinafter, Defective Construction); Clifford J. Shapiro, Further Reflections—Inadvertent Construction Defects are an "Occurrence" Under Commercial General Liability Policies, 686 PLI/LIT 73, 82 (2003). 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 Constr. 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). *Weedo* is perhaps the most widely cited opinion by CGL insurers. Likewise, CGL insurers oftentimes rely on McCord, Condron & McDonald, Inc. v. Twin City Fire Ins. Co., 607 S.W.2d 956 (Tex. Civ.App.— Ft. 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. See Lennar Corp. v. Great Am. Ins. Co., 2006 WL 406609 (Tex. App.—Houston [14th Dist.] Feb. 23, 2006, pet. filed) (op. on reh'g) (not designated for publication). Moreover, case law construing exclusions is not relevant in determining whether the insuring agreement has been satisfied by allegations of defective construction. *See Id.*

[33] Great Am. 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. Mid-Continent Cas. Co., 2003 WL 22116202 (S.D. Tex. Sept. 8, 2003) (not designated for publication); *Lennar Corp.*, 2006 WL 406609, at *9-*10; Gehan Homes, Ltd. v. Employers Mut. Cas. Co., 146 S.W.3d 833, 843 (Tex. App.—Dallas 2004, pet. filed).

[34] Erie Ins. Exch. v. Colony Dev. Corp., 736 N.E.2d 941, 947 (Ohio App. 1999); *see also* Am. Family Mut Ins. Co. v. Am. Girl, Inc., 673 N.W.2d 65, 74-79 (Wis. 2004).

[35] Mid-Continent and its sister company Great American have been unsuccessful in its arguments on this very fact pattern. State court cases involving Mid-Continent or Great American: Summit Custom Homes, Inc. v. Great Am Lloyds Ins. Co., 2006 WL 1985964 (Tex. App.—Dallas July 18, 2006, no pet. H.); Pine Oak Builders, Inc. v. Great Am. Lloyds Ins. Co., 2006 WL 1892669 (Tex. App.—Houston [14th Dist.] July 6, 2006, no pet. h.); Archon Investments, Inc. v. Great Am. Lloyds Ins. Co., 174 S.W.3d 334 (Tex. App.—Houston [1st Dist.] 2005, pet. filed); Lennar Corp. v. Great Am. Ins. Co., 2006 WL 406609 (Tex. App.—Houston [14th Dist.] Feb. 23, 2006, pet. filed) (op. on reh'g) (not designated for publication); Gehan Homes, Ltd. v. Employers Mut. Cas. Co., 146 S.W.3d 833 (Tex. App.—Dallas 2004, pet. filed). Federal court cases involving Mid-Continent or Great American: Home Owners Mgmt. Enters. v. Mid-Continent Cas. Co., 2005 WL 2452859 (N.D. Tex. Oct. 3, 2005); Luxury Living, Inc. v. Mid-Continent Cas. Co., 2003 WL 22116202 (S.D. Tex. Sept. 10, 2003) (not designated for publication); Great Am. Ins. Co. v. Calli Homes, 236 F. Supp. 2d 693 (S.D. Tex. 2002); First Tex. Homes, Inc. v. Mid-Continent Cas. Co., 2001 WL 238112 (N.D. Tex. Mar. 7, 2001), *aff'd*, 2002 WL 334705 (5th Cir. 2002) (not designated for publication). For the most recent pronouncement against these cases, *see* Grimes Constr., Inc. v. Great Am. Lloyds Ins. Co., 2006 WL 563286 (Tex. App.—Fort Worth Mar. 9, 2006, pet. filed). A chart that includes all of the Texas case law that falls within this fact pattern is included in an Appendix to this article.

strates the fallacy of Mid-Continent's contention that the insuring agreement combined with some sort of business risk or economic loss rationale, operates to negate any and all coverage for defective workmanship claims.[36]

As will be discussed, neither Lamar Homes before the Texas Supreme Court nor these authors have taken the position that all contractual breaches should result in coverage under a CGL policy. Quite to the contrary, "CGL policies generally do not cover contract claims arising out of the insured's defective work or product, but this is by operation of the CGL's business risk *exclusions*, not because a loss actionable only in contract can never be the result of an 'occurrence' within the meaning of the CGL's policy initial grant of coverage."[37]

A. THE INSURING AGREEMENT

The insuring agreement includes the "occurrence" and "property damage" requirements. As noted, CGL insurers, with increasing frequency, focus on the insuring agreement rather than on the construction-specific exclusions in determining coverage for construction defects.[38] This truncated analysis of the CGL policy is undertaken to avoid the limiting effect of the construction-specific exclusions that oftentimes do not apply to negate coverage in its entirety.

1. The "Occurrence" Requirement

CGL insurers frequently raise the "occurrence" requirement as a defense to coverage in defective construction cases. The term "occurrence" in a CGL policy "means an accident, including continuous or repeated exposure to substantially the same general harmful conditions." Perhaps part of the problem stems from the fact that the term "accident" is undefined. In fact, one commentator noted that the term "'accident' remains a 'blob of jelly' as a legal construct."[39]

The Supreme Court of Texas has noted that an "accident" includes damage that is the unexpected, unforeseen or undesigned happening or consequence of an insured's negligent behavior.[40] 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.'"[41]

Thus, according to the Supreme Court in *Lindsey*, 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 (i.e., a subjective inquiry); and (ii) the reasonably foreseeable effect of the actor's conduct (i.e., an objective inquiry).[42]

Some CGL insurers that take a narrow view of coverage improperly focus on the second prong of the *Lindsey* test and, in particular, on the "reasonably foreseeable effect" language. The problem with such a focus, however, is that it unduly concentrates on foreseeableiility of the effect. Notably, the fact that the consequences of a particular act and/or omission may be foreseeable in the tort sense does not mean that the consequences are not accidental for purposes of determining coverage. Foreseeability, it must be remembered, is a required element to prove negligence. Thus, if a purely objective standard along fore-

[36] *See Am. Family Mut.*, 673 N.W.2d at 78 ("Why would the insurance industry exclude damage to the insured's own work or product if the damage could never be considered to have arisen from a covered 'occurrence' in the first place?").

[37] *See Am. Family Mut.*, 673 N.W.2d at 76 (emphasis added); *see also Colony Dev. Corp.*, 736 N.E.2d at 949; *Lennar Corp.*, 2006 WL 406609, at 10.

[38] This article is not intended to be an indictment of all CGL carriers. Many CGL carriers properly analyze the policy as a whole and apply it as written. That being said, certain insurers like Mid-Continent Casualty Company and Great American Lloyds Insurance Company in Texas have taken a particularly narrow view of CGL coverage.

[39] Marc Meyerson, *The Faulty Workmanship of the Courts*, INSURANCE SCRAWL, http://www.insurancescrawl.com/archives/2005 (citing David Mellinkoff, *The Language of the Law* 377 (1963)). 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, 2d 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.*

[40] *See* Mass. Bonding & Ins. Co. v. Orkin Exterminating Co., 416 S.W.2d 396, 400 (Tex. 1967).

[41] Mid-Century Ins. Co. of Tex. v. Lindsey, 997 S.W.2d 153, 155 (Tex. 1999).

[42] *See Id.*

seeability lines is followed, even a finding of negligence would negate coverage. Therefore, CGL policies would provide coverage only for *unforeseeable* consequences—that is, only in those situations where the law would impose no tort liability and where there would be no need for liability coverage in the first place.

This raises the question of why anyone would purchase insurance for *unforeseeable* consequences. Generally speaking, meteorite insurance is not a component of most insureds' coverage portfolios. In addition, if only *unforeseeable* consequences are covered by a policy, there would be no need for insurance companies to hire actuaries. Rather, it is the foreseeability of a loss and the economic consequences from that loss that are at the heart of the underwriting process.Yet another question is how far does the foreseeability theory apply? For example, auto policies also are triggered by "accidents." If an insured driver runs a red light and causes a collision or is speeding and collides with another vehicle, are those collisions no longer accidents? Certainly, in a purely objective sense, it is foreseeable that if a driver runs a red light that a collision may occur. The reason that auto insurers routinely pay such losses, however, is that the driver (although violating the law and likely the recipient of a citation) neither expected nor intended to cause the collision. Why should the undefined term *accident* mean anything different in the context of a CGL policy, especially where the term "accident" is but a component of occurrence-based coverage under the CGL policy?

Although Mid-Continent claims to be applying the *Lindsey* test as written, subsequent authority from the Supreme Court of Texas has cast significant doubt on Mid-Continent's interpretation of the "occurrence" requirement. More specifically, in *King v. Dallas Fire Insurance Company*, 85 S.W.3d 185 (Tex. 2002), the Supreme Court restricted a "reasonably foreseeable" or "reasonably anticipated" inquiry to situations when an insured seeks coverage for its intentional conduct.[43] Moreover, the *King* case makes clear that courts must focus on the unexpected or unintended results from the standpoint of the insured. It must be noted that in *King,* the Court considered and applied the standard definition of "occurrence" from the standard form CGL policy, and not the term "accident" as borrowed from an auto policy in *Mid-Century v. Lindsey, supra.* The Court specifically warned against reading the "occurrence" definition so narrowly as to "obviate the need for many other standard exclusions often contained in CGL policies."[44] Nevertheless, insurers such as Mid-Continent refuse to pay heed to that warning, persisting in arguments that render the business risk exclusions mere surplusage.[45]

Insurers respond that insureds seeking coverage for defective work are simply arguing that it should be enough for an insured to simply say, "I didn't mean it." Lamar Homes did not make that argument before the Supreme Court. Moreover, the mere allegation of negligence may not be sufficient to trigger coverage or the potential for coverage. Rather, a synthesis of *Lindsey* and *King* as well as prior precedent from the Supreme Court of Texas demonstrates that the "accident"/"occurrence" analysis boils down to a two-part test:

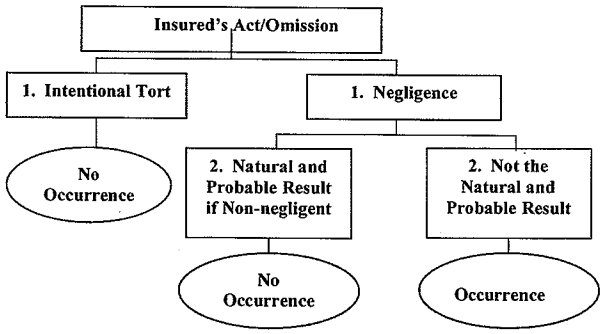
STEP 1: Did the insured's conduct rise to the level of an intentional tort?

- 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.
- If "no," then the conduct constitutes an "occurrence."

A flowchart depicting these steps is as follows:



Step one addresses intentional torts. The Supreme

[43] *Id.* at 190.

[44] *Id.* at 193.

[45] In *King*, the Supreme Court relied heavily on the APPLEMAN ON INSURANCE treatise and its discussion of the "occurrence" requirement. The APPLEMAN treatise, which also was cited by Mid-Continent in its briefing, squarely rejects the use of foreseeability or any sort of "natural or probable consequence" test in determining whether the "occurrence" definition has been satisfied. *See* ERIC MILLS HOLMES, APPLEMAN ON INSURANCE 2d, §§ 117.1 -117.5, 118.1-118.2 (2000). The APPLEMAN treatise, consistent with the holding in *King*, recognizes that an objective test along foreseeability lines would essentially negate coverage in most circumstances. *See Id.*

Court of Texas has made it clear that intent to injure is presumed in the context of intentional torts.[46] Accordingly, for this step, it makes no difference whether the insured actually intended to cause the damage.[47]

Step two addresses negligence-based or inadvertent conduct and focuses on the expected or intended nature of the resulting damage. The term "accident" includes the "negligent acts of the insured causing damage which is undesigned and unexpected."[48] Thus, "[i]f intentionally performed acts are not intended to cause harm, but do so because of negligent *performance*, a duty to defend arises."[49] Stated otherwise, "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."[50]

Recognizing that an objective test along foreseeability lines would render liability coverage illusory, the second step focuses on whether the resulting damage was inevitable regardless of how the insured acted. The perfect example is *Martin Marietta Materials Sw., Ltd. v. St. Paul Guardian Ins. Co.*, 145 F. Supp. 2d 794 (N.D. Tex. 2001). The *Martin Marietta* case involved a lawsuit by downstream users arising out of the insured's impounding of Big Sandy Creek. The Court found that the purposeful diversion of water would result in an inevitable reduction of downstream waters regardless of whether the insured's acts and/or omissions constituted negligence.[51]

Often, insurers argue that no "occurrence" can exist in the context of damage to the work itself because the performance of a construction contract by an insured is a voluntary and intentional act. Essentially, by virtue of the construction contract between the general contractor and the owner, a general contractor presumptively expects or intends any property damage to its work—regardless of the general contractor's actual expectation or intent. In this sense, insurers that ascribe to the arguments made by Mid-Continent, rather simplistically treat construction defects as intentional torts. While it is beyond dispute that the construction of a home or building is a deliberate or volitional act, that fact does not result in the conclusion that damage to the work itself runs afoul of the "occurrence" requirement. In fact, if such a narrow interpretation of the "occurrence" requirement is correct, then insurance covers everything except for what happens.

Fortunately, the Supreme Court of Texas has at least implicitly rejected such a narrow view of the "occurrence" requirement.[52] In *Cowan*, the Court 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.[53] The Supreme 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."[54]

Other courts likewise have followed this rationale as applied to construction defect claims arising out of the work of subcontractors of the insured general contractor.[55]

Consistent with the two-part test set out above, courts have recognized that two lines of "occurrence" cases

[46] *See* Argonaut Ins. Co. v. Maupin, 500 S.W.2d 633, 635 (Tex. 1973).

[47] *See Id.*

[48] *See Orkin*, 416 S.W.3d at 400.

[49] CU Lloyd's of Tex. v. Main Street Homes, 79 S.W.3d 687, 693 (Tex. App.—Austin 2002, no pet.).

[50] Harken Exploration Co. v. Sphere Drake Ins. PLC, 261 F.3d 466, 473 (5th Cir. 2001).

[51] *See* Mt. Hawley Ins. Co. v. Steve Roberts Custom Builders, Inc., 215 F. Supp. 2d 783, 790 n.2 (E.D. Tex. 2002) (discussing *Martin Marietta* and contrasting it with a construction defect case); *see also Lennar Corp.*, 2006 WL 406609, at * 8 n.18 ("We do not examine whether the damage was expected from the improper, i.e., negligent performance of the contract .... Instead, we examine whether the damage was expected if the work was performed properly, i.e., non-negligently.").

[52] *See* Trinity Universal Life Ins. Co. v. Cowan, 945 S.W.2d 819, 828 (Tex. 1997).

[53] *See Id.*

[54] *Id.*

[55] *See Home Owners Mgmt.*, 2005 WL 2452859, at *6 ("The Twomeys never alleged that Holmes-Redding intended to cause foundation damage to the home. Instead, the Twomeys claimed that Holmes-Redding negligently caused the foundation damage. An allegation of negligence constitutes an accidental 'occurrence' under the policy and is sufficient to trigger Mid-Continent's duty to defend."); *Archon Investments*, 174 S.W.3d at 340 ("If intentionally performed acts are not intended to cause harm, but do so because of negligent performance, a duty to defend arises."); *Lennar Corp.*, 2006 WL 406609, at *10 ("Accordingly, we agree with the cases cited by Lennar because the courts recognized that the 'occurrence' requirement can encompass damage to the insured's own work, and coverage then depends upon the exclusions."); Mid-Continent Cas. Co. v. JHP Dev., Inc., 2005 WL 1123759, at *4 (W.D. Tex. Apr. 21, 2005) ("After examining the policy's definition of 'occurrence' and the lack of allegations that JHP intentionally caused the damage, the Court concludes that there was an 'occurrence' under the CGL policy."); *Gehan Homes*, 146 S.W.3d at 843 ("In this case, the intentional act of performing the contract was allegedly performed negligently. The purported damage was an unexpected and undesigned consequence of Gehan's alleged negligence."); *Luxury Living*, 2003 WL 22116202, at *16 ("[T]he court finds that the underlying lawsuit against Luxury contains general allegations of negligence, rendering the damages to the Wards' residence an 'accident' thus constituting an 'occurrence' within the scope of the Policy."); *Calli Homes*, 236 F. Supp. 2d at 698 ("[A]lthough the work was voluntarily and intentionally performed, it was undertaken with the intent to perform properly and the consequences of inadvertent construction defects are 'accidental.'"); *Steve Roberts Custom Builders*, 215 F. Supp. 2d at 791 ("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."); *Main Street Homes*, 79 S.W.3d 687 at 693 ("[I]f intentionally performed acts are not intended to cause harm but do so because of negligent *performance*, a duty to defend arises."); *First Texas Homes*, 2001 WL 238112, at *3 ("The paramount consideration for coverage purposes is whether the resulting damage was unexpected or unintended.").

exist in Texas: one for intentional torts (i.e., the *Maupin* line) and one for non-intentional actions (i.e., the *Orkin* line).[56] Under the *Maupin* line for intentional torts, as previously noted, no "occurrence" exists regardless of whether the insured subjectively expected or intended the injury.[57] Under the *Orkin* line for non-intentional conduct, an "occurrence" exists even if the act is deliberate as long the damages were neither expected nor intended.[58]

Ignoring this distinction, insurers such as Mid-Continent instead focus solely on the general contractor's contractual undertaking. In so doing, they take the position that damage to the work itself cannot be an "occurrence" as a matter of law. Again, Mid-Continent's argument fails to take into account the actual definition of "occurrence." Notably, the definition of "occurrence" does not depend on the character of the property that is damaged. It is the *exclusions* rather than the insuring agreement that "render the existence of third-party property damage a critical element of most defective work claims. Consider an example where a claim is made against the homebuilder for a defective foundation. The foundation was poured by a subcontractor and is causing widespread cracking throughout the home. Under the "third-party property damage" loss on the definition of "occurrence," there is no coverage because the entire home is the work of the homebuilder. On the other hand, where the unexpected and unintended nature of the property damage is recognized as an occurrence, and the exclusions are then applied, the home builder will be entitled to coverage for the property damage to the home arising out of its subcontractor's defective work based on the subcontractor exception to the "your work" exclusion. Thus, for purposes of defining whether there has been an "occurrence," it is immaterial whether the damage is to the home itself versus third-party property.

Although the case law is decidedly split, as is evident from the Appendix to this article, the better reasoned authorities have rejected a damage-to-third-party-property requirement in favor of reading the policy as a whole. One court, for example, correctly rejected an attempt to amend the definition of "occurrence" to add a requirement of damage to third-party property:

> 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 the 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."[59] 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.[60]

Other courts similarly have concluded that damage to the work itself constitutes an "occurrence" so long as the damage was unexpected or unintended from the standpoint of the insured.[61] Other courts, while not directly addressing the issue, likewise have found coverage even when the damages were restricted to the homes themselves.[62] No logical basis exists within the "occurrence" definition for distinguishing between damage to the work itself versus damage to some third-party property:

> 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.

[56] *See Home Owners Mgmt.*, 2005 WL 2452859, at *4-5; *Gehan Homes*, 146 S.W.3d at 839; *Luxury Living*, 2003 WL 22116202, at *13-15; *Calli Homes*, 236 F. Supp. 2d at 699; *Steve Roberts Custom Builders*, 215 F. Supp. 2d at 788; *Main Street Homes*, 79 S.W.3d at 693; *Grapevine Excavation*, 197 F.3d at 723-25.

[57] *See Harken*, 261 F.3d at 472.

[58] *See Id.*

[59] *Grapevine Excavation*, 197 F.3d at 725.

[60] *First Texas Homes*, 2001 WL 238112, at *3.

[61] *See, e.g., Archon Investments*, 174 S.W.3d at 341-42 ("Although property damage to Archon's work is excluded from coverage under the terms of the policy, that exclusion does not apply if the damage to property occurred after the house was completed and sold if the work out of which the damage arose was performed on Archon's behalf by a subcontractor."); *Lennar Corp.*, 2006 WL 406609, at *12 ("In sum, reading the standard CGL policy as a whole, we hold that negligently created, or inadvertent, defective construction resulting in damage to the insured's own work that is unintended and unexpected can constitute an 'occurrence.'"); *JHP Dev.*, 2005 WL 1123759, at *4 ("Apparently, it is Mid-Continent's position that if there were other builders on site at the property and JHP unintentionally damaged their work, there would be coverage. However, that is not how the term 'occurrence' has been defined in the agreement."); *Gehan Homes*, 146 S.W.3d at 843 ("The insurers also argue that since the claim is damage to the house, the subject of the contract, there is no occurrence. We recognize that some courts have based their decision on that basis. However, several courts have held that negligence that results in damage to the subject matter of the contract, the house, constitutes an 'occurrence,' because the relevant inquiry is not whether the insured damaged his own work, but whether the resulting damage was unexpected or unintended. We agree with this latter analysis.").

[62] *See, e.g., Home Owners Mgmt.*, 2005 WL 2452859, at *6 (finding coverage for a general contractor even though the damages were to the home itself); *Luxury Living*, 2003 WL 22116202, at *16 (same); *Calli Homes*, 236 F. Supp. 2d at 702 (same); *Main Street Homes*, 79 S.W.3d at 687 (same).

> 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 an occurrence but by application of the standard "work performed" and "work product" exclusions found in a Commercial general liability policy.[63]

Moreover, the "subcontractor exception" language to exclusion L clearly signifies that the CGL policy contemplates coverage for physical damages to the work itself. In fact, there would be no need for the "your work" or "your product" exclusions if the insuring agreement already "excluded" damage to the work or product itself.[64]

In sum, plugging the facts of *Lamar Homes v. Mid-Continent* into the "occurrence" flowchart described above makes it even clearer that the "occurrence" requirement has been satisfied—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 free of cracks in the stone veneer and sheetrock. Moreover, since the foundation work was designed by an engineer, constructed by a subcontractor, and then inspected and approved by the engineer, how can it be concluded that the damages were expected or intended from the standpoint of the insured, Lamar Homes.?

2. The "Property Damage" Requirement

The policy covers "property damage" caused by an "occurrence," and defines "property damage," in part, as "physical injury to tangible property." Similar to the argument raised in connection with the "occurrence" requirement, insurers often contend that defective construction claims fail to allege "property damage" because damage to the home or project itself constitutes a mere economic loss. Mid-Continent made this argument before the Supreme Court in *Lamar Homes.* That contention, however, does not comport with the definition of "property damage" in the policy. More specifically, the definition of "property damage" *does not* state and certainly *does not* require "physical injury to tangible property *of others,*" or "physical injury to tangible property *of third parties*", or "physical injury to *work beyond the scope of the contractual undertaking.*" Rather, by its explicit terms, the "property damage" definition only requires that there be physical injury to tangible property.

One federal court expressly rejected the narrow interpretation of the "property damage" definition that Mid-Continent advocates in *Lamar Homes*:

> 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.[65]

Other courts likewise have rejected the contention that property damage must be to property owned by a third party.

> Travelers claims that the trial court erred by concluding that Diamaco met its threshold burden of establishing that the "property damage" here was within the insuring clause of the policies... Travelers argues that Diamaco's claim was not eligible for coverage as "property damage" because there was no damage to the property of others, only to the property of the insured. We reject this argument. . . . Had Travelers intended to exclude from its insuring clause the property of the insured in this case, it could easily have done so . . . .[66]

As one commentator has noted:

> Either there is physical injury to tangible property or there is not. Nothing more is required to reach a finding that "property damage" exists. . . . There is no policy requirement that physical injury occur to a particular class, i.e., other people's property, in order for "property damage" to exist.[67]

In reality, the "necessity" for third party property damage is one of the myths that has emerged from case law interpreting the CGL policy. As can be seen, nowhere in the

[63] Erie Ins. Exch. v. Colony Dev. Corp., 736 N.E.2d 950, 952 n.1 (Ohio App. 2000); *see also Lennar Corp.*, 2006 WL 406609, at *8 n.18 ("However, we do not see how damage to the insured's own work is any more expected than damage to the work or property of a third-party if the faulty construction was inadvertent").

[64] Since exclusion L applies only to "your work," the "subcontractor exception" by necessity preserves coverage for property damage to the home itself. *See* Kalchthaler v. Keller Constr. Co., 591 N.W.2d 169, 174 (Wis. App. 1999); O'Shaughnessy v. Smuckler Corp., 543 N.W.2d 99, 104-05 (Minn. App. 1996). In fact, since the CGL policy already covers damage to third-party property, the subcontractor exception would be unnecessary. *See O'Shaughnessy*, 543 N.W.2d at 104-05 ("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.").

[65] Fid. & Deposit Co. v. Hartford Cas. Ins. Co., 189 F. Supp. 2d 1212, 1220 (D. Kan. 2002).

[66] Diamaco, Inc. v. Aetna Cas. & Sur. Co., 983 P.2d 707, 709-11 (Wash. App. 1999).

[67] BRUNER & O'CONNOR, at § 11:34 at p. 114.

definition of "property damage" is there any hint of a third-party property damage requirement; rather, it is the exclusions directed at limiting coverage for property damage involving the insured's own defective work that render the existence of third-party property damage an important element of most defective work claims.

Texas courts have recognized this fact and, for the most part, rejected the view that the damage must extend beyond the work itself.[68] The case law relied upon by Mid-Continent in making its "property damage" arguments to the Texas Supreme Court is misplaced and simply stands for the unremarkable proposition that *purely* economic losses tied to misrepresentations or failures to disclose do not constitute "property damage."[69] Those cases are distinguishable from a construction defect case on the basis that they did not involve physical injury to tangible property that allegedly was caused by the insured or its subcontractors' expected and unintended conduct. Rather, those cases involve negligent or fraudulent misrepresentations or failures to disclose *pre-existing* damage or damage to *intangible* property. Cases of this sort have been properly rejected in the context of a suit against a general contractor for faulty workmanship.[70] Simply put, it is one thing to allege that an insured misrepresented the existence of pre-existing damage caused by others; it is quite another to allege that the insured caused the damage.

Even so, in an effort to avoid the actual policy language, insurers such as Mid-Continent simply seeks to recast physical damage to tangible property as "economic loss." In essence, they simply call it something else. While it is true that *purely* economic losses are not covered (i.e., economic losses not tied to any "property damage"), the same is not true for consequential economic losses that arise from or relate to "property damage" (i.e., physical injury to tangible property and/or loss of use).[71]

CGL policies unambiguously cover consequential economic damages. The proof is in the policy itself. In particular, the policy's insuring agreement states: "We will pay those sums that the insured becomes legally obligated to pay as damages *because of* . . . 'property damage.'" The words "because of" indicate that all that matters is that the legal liability have as its source, or arise from, physical injury to or loss of use of tangible property. Accordingly, once "property damage" has been established, the policy then covers economic losses that flow because of the "property damage."[72]

In *Lamar Homes,* the DiMares alleged, *inter alia*, cracks in the stone veneer and sheetrock. While the DiMares may have sought economic damages in the form of money against Lamar Homes, it is difficult to discern how such damages do not meet the "property damage" requirement.

3. The Proper Role of the "Property Damage" and "Occurrence" Requirements

One of the favorite arguments of insurers such as Mid-Continent is a "sky is falling" approach, i.e., that a finding in favor of coverage will result in contractors being covered for all of their punch-list and/or warranty work. This argument is completely without merit. Insureds do not contend that all construction defects are covered under a CGL policy. In fact, it is the insurers that ignore the existence of the various construction-related exclusions that are designed to delineate the precise scope of coverage for construction-related defects. Those exclusions would bar coverage for many "punch-list" or "warranty" items. For example, exclusions J(5)[73] and J(6)[74] exclude many

[68] *See Home Owners Mgmt.*, 2005 WL 2452859, at *7 (holding that damages awarded by arbitrator to homebuyers to compensate them for repairs necessitated by a faulty foundation constituted "property damage" under a CGL policy); *Lennar Corp.*, 2006 WL 406609, at *15 (holding that costs to repair water damage caused by defective EIFS constituted "property damage" within the meaning of a CGL policy); *JHP Dev.*, 2005 WL 1123759, at *4-5 (rejecting breach of contract/economic loss analysis and concluding that allegation of damage to the work was all that was necessary to satisfy "property damage" definition); *Gehan Homes*, 146 S.W.3d at 844 (same); *Luxury Living*, 2003 WL 22116202, at *16 (same); *First Tex. Homes*, 2001 WL 238112, at *2 (same).

[69] For example, *see* State Farm Lloyds v. Kessler, 932 S.W.2d 732 (Tex.App.—Fort Worth 1996, writ denied) (economic damages due to misrepresentation by seller of home about pre-existing property damage); Terra International, Inc. v. Commonwealth Lloyds Insurance Company, 829 S.W.2d 270 (Tex.App.—Dallas 1992, writ denied) (fraudulent misrepresentations as to property located in flood control district); Great American Lloyds Insurance Company v. Mittlestadt, 109 S.W.3d 784 (Tex.App.—Fort Worth 2003, no pet.) (inability to sell home due to encroachment on pipeline easement); and Lay v. Aetna Insurance Company, 599 S.W.2d 684 (Tex.App.—Austin 1980, writ ref'd n.r.e.)(economic loss from negligent failure to locate an oil well).

[70] *See JHP Dev.*, 2005 WL 1123759, at *5.

[71] *See Lennar Corp.*, 2006 WL 406609, at *12-16 (rejecting insurer's attempt to recast physical injury to tangible property as an uncovered mere economic loss); *JHP Dev.*, 2005 WL 1123759, at *4-5 (same); *Gehan Homes*, 146 S.W.3d at 844 (same); *Luxury Living*, 2003 WL 22116202, at *16 (same).

[72] *See* Riley Stoker Corp. v. Fid. & Guar. Ins. Underwriters, Inc., 26 F.3d 581 (5th Cir. 1994) (finding coverage for consequential economic losses arising from loss of use of plant's electric generators); Home Assurance Co. v. Libbey-Owens-Ford Co., 786 F.2d 22 (1st Cir. 1986) (finding coverage for consequential losses stemming from physical injury to windows even though there was no coverage for the repair and replacement of the windows themselves); *see also* DONALD S. MALECKI & ARTHUR L. FLITNER, COMMERCIAL GENERAL LIABILITY 8-9 (7th ed. 2001) ("In light of [the 'because of'] wording, all damages flowing as a consequence of bodily injury or property damage would be encompassed by the insurer's promise, subject to any applicable exclusion or condition. This includes purely economic damages, as long as they result from otherwise covered bodily injury or property damage."); WIELINSKI, DEFECTIVE CONSTRUCTION, at 121-23; ALLAN D. WINDT, INSURANCE CLAIMS & DISPUTES, REPRESENTATION OF INSURANCE COMPANIES AND INSUREDS § 11:1, at p. 285 (4th ed. 2001 & Supp. 2005) (hereinafter INSURANCE CLAIMS & DISPUTES).

[73] Exclusion J(5) bars coverage for "[t]hat particular part of real property on which you [the named insured] or any contractors or subcontractors working directly or indirectly on your behalf are performing operations, if the 'property damage' arises out of those operations."

[74] Exclusion J(6) bars coverage for "[t]hat particular part of any property that must be restored, repaired or replaced because 'your work' [the named insured's work] was incorrectly performed on it."

types of damages that take place during the course of construction, and no subcontractor exception applies to those exclusions. Additionally, by its own terms, exclusion L eliminates coverage for damages to the insured's completed work that are caused by the insured's own faulty work.

Even aside from the exclusions, the "property damage" and "occurrence" requirements do have a role in the initial coverage analysis. If, for example, a contract called for painting the interior of a house white but the painting subcontractor painted the interior red, there would be no coverage under the CGL policy because the "property damage" definition would not be satisfied (i.e., the wrong paint color does not constitute "*physical* injury to tangible property" as required by the CGL policy). Likewise, if a contractor installed all of the windows backwards and discovered the defect prior to any resulting damage, there would be no coverage for the same reason since the mere faulty installation, in and of itself, does not constitute physical injury to the home. If, however, the improperly installed windows caused water intrusion and that water intrusion physically damaged the building, then the requisite physical injury to tangible property requirement of the "property damage" definition has been satisfied.

The "occurrence" analysis is similar. If the contractor did not intend to install the windows backwards, but rather did so because of a misreading of the specifications, that conduct would be considered accidental and the resulting water damage would be deemed to be accidental as well. If, however, the contractor purposefully installed the windows backwards because doing so would take half the time and would thus be a cost savings to the contractor, then it is questionable whether the "accident" component of the "occurrence" requirement has been satisfied.[75]

It must be noted that the accident is not the faulty workmanship itself—rather, the accident is the unexpected or unintended damage that results from the faulty workmanship.[76] In other words, CGL policies do not cover the accident of faulty workmanship; instead, CGL policies cover an accident caused by faulty workmanship. In *Lamar Homes*, for example, the allegedly poorly designed or constructed foundation, in and of itself, would not trigger coverage. The resulting physical damage to the DiMares' home, however, constitutes physical damage to tangible property that was unexpected or unintended from the standpoint of Lamar Homes. Likewise, the mere repair or replacement of defective EIFS installed on a house does not trigger coverage. But, damages caused by water intrusion behind the defective EIFS triggers coverage under a CGL policy.[77]

Certainly, case law exists that rejects coverage under similar scenarios. As one court correctly noted, however, most of the case law that supposedly supports the insurer's position falls into one of three categories: (i) case law that addresses situations in which no property damage was caused, such as mere unfinished work; (ii) case law that involves claims to replace or repair defective material that causes no property damage; or (iii) case law that construed and applied policy exclusions rather than the insuring agreement.[78] Another court noted that some of these supposedly pro-insurer decisions have resulted in some "regrettably overbroad generalizations about CGL policies . . . ."[79] A closer look at the case law that cited by Mid-Continent to the Texas Supreme Court demonstrates that some of the cases fall into the three categories described in the *Lee Builders* case. Other cases simply follow the aforementioned "regrettably overbroad generalizations" without analyzing the policy as a whole.

B. THE EXCLUSIONS

Coverage for defective construction claims, in most cases, should be decided by analyzing the exclusions in the CGL policy. While the term "business risk exclusions" encompasses exclusions J(5), J(6), K, L, M, and N, the three main exclusions for purposes of determining the scope of coverage for physical injury to tangible property are exclusions J(5), J(6), and L. It is these exclusions that also make distinctions between the work and third party property for purposes of determining coverage.

This section of the article will demonstrate that these three exclusions do not negate coverage in *Lamar Homes*. As a practical matter, this fact went uncontested by Mid-Continent at the Fifth Circuit and Supreme Court. For that matter, Mid-Continent did not raise *any* of the business risk exclusions on appeal. Even so, in order to demonstrate the fallacy of Mid-Continent's reliance on the insuring agreement and definitions, a brief discussion of exclusions J(5), J(6) and L is warranted.[80] Notably, the

[75] Intentionally substituting inferior building materials, stealing from the construction account, and walking off the job before the construction is complete are all examples of conduct that would result, and properly so, in a finding of no "occurrence" even if the claimant attempted to couch the allegations in terms of negligence. *See, e.g.*, Jim Johnson Homes, Inc. v. Mid-Continent Cas. Co., 244 F. Supp. 2d 706 (N.D. Tex. 2003); Devoe v. Great Am. Ins. Co., 50 S.W.3d 567 (Tex. App.—Austin 2001, no pet.). The unique facts of those cases actually support a finding of no "occurrence." In fact, in *Lennar Corp.*, the court noted that "we would likely agree with the result in *Jim Johnson Homes* based on its recited facts although we disagree with the court's suggestion that no damage arising from defective construction can result from an occurrence." *Lennar Corp.*, 2006 WL 406609, at *11 n.28.

[76] *See, e.g.*, General Acrylics, Inc. v. Maryland Cas. Co., 2006 WL 898163 (D. Ariz. Apr. 5, 2006).

[77] *See Lennar Corp.*, 2006 WL 406609, at *15-*16.

[78] *See* Lee Builders, Inc. v. Farm Bureau Mut. Ins. Co., 104 P.3d 997, 1002 (Kan. App. 2005), *affd* 2006 WL 1561294 (Kan. 2006).

[79] *Am. Family Mut.*, 673 N.W.2d at 76.

[80] A prior version of this article, published at 5:1 J. TEX. INS. L. 37 (Feb. 2004), undertook a more complete analysis of the various business risk exclusions. *See also* WIELINSKI, DEFECTIVE CONSTRUCTION, chs. 9, 10, 11 and 16.

fact that none of the construction-specific exclusions negate coverage in many of these cases is the very reason that insurers such as Mid-Continent try so hard to avoid any discussion of the exclusions. In fact, in its briefing to the Texas Supreme Court, Mid-Continent argued that any discussion of the exclusions was irrelevant.

1. Exclusion J(5)—the "Operations" Exclusion

The first coverage-specific exclusion is J(5). This exclusion eliminates coverage for "that particular part of real property on which you [the named insured] or any contractors or subcontractors working directly or indirectly on your behalf are performing operations, if the 'property damage' arises out of those operations." Exclusion J(5), by its terms, applies even when a subcontractor performs the work. Even so, also by its express terms, exclusion J(5) applies only to damages that occur *while* operations are being performed.[81] In *Lamar Homes*, it was undisputed that the damage to the home was discovered after its sale to the DiMares. As such, exclusion J(5) is inapplicable.

2. Exclusion J(6)—"Faulty Workmanship" Exclusion

The second construction-specific exclusion is J(6). 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." The term "your work" is defined as "[w]ork or operations performed by you or on your behalf; and [m]aterials, parts or equipment furnished in connection with such work or operations."The exclusion goes on to state, however, that it "does not apply to 'property damage' included in the 'products-completed operations hazard.'" The policy defines 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, exclusion J(6) only applies to work that has not been completed or has been abandoned.

Thus, damage that occurs to a completed home or building does not fall within the scope of exclusion J(6).[82] No dispute exists that the damage in *Lamar Homes* fell within the "products-completed operations hazard" since it occurred after the home already was sold to the DiMares. Moreover, even had the damages occurred during the course of construction, the exclusion does not apply if the defective work causes damage to other work of the insured that was otherwise not defective.[83]

3. Exclusion L—"Your Work" Exclusion

The third construction-specific exclusion, in contrast to exclusions J(5) and J(6), does apply to damages that fall within the "products-completed operations hazard." Exclusion L negates coverage as follows:

> **l. Damage to Your Work**
> "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.*

(emphasis added). 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. Absent both elements, the exclusion simply does not apply.

Notably, the so-called "subcontractor exception" to the "your work" exclusion (i.e., the italicized language above) represents a major extension of coverage for defective workmanship that causes "property damage." The *only* damage that remains excluded after application of the exception is damage to the named insured contractor's own work arising out of the named insured contractor's own work. Damage to a 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. Thus, if a general contractor becomes liable for damage to work performed by a subcontractor—or for damage to the general contractor's own work arising out of a subcontractor's work—the exclusion by its express terms does not negate coverage.[84]

Noted commentators, writing during the time the "sub-

[81] *See Lennar Corp.*, 2006 WL 406609, at *22 ("Giving the exclusion its plain meaning, the use of the present tense indicates the exclusion applies only to 'property damage' arising *while* Lennar is *currently* working on a project."); *JHP Dev.*, 2005 WL 1123759, at *7 ("There is no evidence that JHP was working or performing operations at the time the damage occurred."); *Luxury Living*, 2003 WL 22116202, at *17 (noting that exclusion J(5) could not apply because the underlying plaintiff claimed damage to the home after its closing); *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.").

[82] *See Luxury Living*, 2003 WL 22116202, at *18 ("[T]he property damage to the Wards' home is, by definition, part of the 'products-completed operations hazard,' as Luxury no longer owns or rents the Wards' residence and the work done on the house has long been completed."); *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).

[83] *See JHP Dev.*, 2005 WL 1123759, at *8.

[84] *See Archon Investments*, 174 S.W.3d at 342. ("[W]e conclude, based on a plain reading of the entire policy, including the subcontractor exception, that Braden's pleadings allege a claim potentially within the scope of coverage of the CGL policy."); *Lennar Corp.*, 2006 WL 406609, at *10 ("More significantly, coverage for some 'business risks' is *not* eliminated when the damaged work, or the work out of which the damage arose, was performed by subcontractors."); *Main Street Homes*, 79 S.W.3d at 697-98 ("Both the . . . petitions allege that the property damage was caused by the subcontractors who designed and constructed the foundations . . . A plain reading of this exclusion in light of the underlying pleadings demonstrates that the subcontractor exception applies and the exclusion does not preclude Lloyd's duty to defend."); *First Texas Homes*, 2001 WL 238112, at *3-*4 (finding the exclusion inapplicable in a defective foundation case against the general contractor because "someone other than First Texas may be responsible for the damages . . . .").

contractor exception" was added to the CGL policy, recognized the effect of the provision:

> There is, however, an exception to exclusion "L" of substantial importance to insured contractors, which provides that "[t]his 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." *This exception should allow for coverage, for example, if an insured general contractor is sued by an owner for property damage to a completed residence, caused by faulty plumbing or electrical work done by a subcontractor.* The coverage in that circumstance should extend to all "work" damaged, whether it was done by the contractor or by any subcontractor, since the "work out of which the damage arises was performed . . . by a subcontractor." The only property damage to completed work which is excluded by exclusion "L" is damage to the insured contractor's work, *which arises out of* the insured contractor's work.[85]

The emphasized example used by Messrs. Hendrick and Wiezel is exactly the type of situation presented in *Lamar Homes.* Other authoritative commentators agree:

> If the policy's exclusion for damage to the insured's work contains a proviso stating that the exclusion is inapplicable if the work was performed on the insured's behalf by a subcontractor, it would not be justifiable to deny coverage to the insured, based upon the absence of an occurrence, for damages owed because of property damage to the insured's work caused by the subcontractor's work. Reading the policy as a whole, it is clear that the intent of the policy was to cover the risk to the insured created by the insured's use of a subcontractor. Moreover, if coverage were never available for damage to the insured's work because of a subcontractor's mistake, on the theory that there was no occurrence even under those circumstances, the foregoing subcontractor proviso to the exclusion for damage to the insured's work would be meaningless, and if possible, policies should not be interpreted to render policy provisions meaningless.[86]

In other words, by incorporating the subcontractor exception into the "your work" exclusion, the insurance industry specifically contemplated coverage for property damage caused by a subcontractor's defective workmanship.[87]

Mid-Continent attempts to circumvent the "subcontractor exception" by focusing on the insuring agreement's threshold requirements of "occurrence" and "property damage." As noted by Windt, and contrary to well-settled contract interpretation rules, that focus renders the "subcontractor exception" as well as the other construction-specific exclusions mere surplusage.[88] In *Lamar Homes,* the home was constructed by subcontractors. Accordingly, exclusion L does not apply.[89]

V. NEITHER THE "BUSINESS RISK" RATIONALE NOR THE "ECONOMIC LOSS" RULE TRUMP THE ACTUAL POLICY LANGUAGE

Recognizing that allegations of defective construction oftentimes 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/or the "economic loss" rule to support their denials of coverage. These defenses, however, have very little to do with the actual policy language.

A. THE "BUSINESS RISK" RATIONALE

The "business risk" rationale, boiled down to its essence, is that defective construction is a business risk within the control of the contractor and thus is not covered by a CGL policy. According to many insurers, damage to the work itself caused by the faulty workmanship of a subcontractor constitutes an uninsurable business risk vis-a-vis the general contractor.[90] The better reasoned authorities construing modern CGL policies, however, recognize that the application of any so-called "business risk" rationale cannot supplant the actual terms of the

[85] James D. Hendrick and James P. Wiezel, *The New Commercial General Liability Forms—An Introduction and Critique*, 36 FED'N INS. CORP. COUNS. Q. 317, 360 (1986) (emphasis added in part).

[86] WINDT, INSURANCE CLAIMS & DISPUTES, at § 11.3.

[87] *See, e.g.*, Limbach Co. v. Zurich Am. Ins. Co., 396 F3d 358, 362-63 (4th Cir. 2005); *Lennar Corp.*, 2006 WL 406609, at *10-*14; *Am. Family Mut.*, 673 N.W.2d at 82.

[88] See *King*, 85 S.W.3d at 193; *Archon Investments*, 174 S.W.3d at 342; *Gehan Homes*, 146 S.W.3d at 843.

[89] The "your work" exclusion would have applied to negate coverage had the foundation been constructed by employees of Lamar Homes as opposed to subcontractors. Again, however, the insurance industry purposefully chose to insure general contractors for the faulty work of their subcontractors.

[90] These arguments misapprehend that although a general contractor may be responsible for the construction of a project, the general contractor cannot control every risk associated with it. As a general contractor's liability policy insures against risks beyond its control, it naturally follows that such risks can arise from a subcontractor's work. In fact, due to the complexities of construction, numerous instances exist when the general contractor knows little, if anything, about the exigencies of the subcontractor's work. To state that a general contractor should not be able to obtain liability insurance against a subcontractor's work because of "business risk" does not reflect the commercial reality of the insured general contractor. *See* Fireguard Sprinkler Sys., Inc. v. Scottsdale Ins. Co., 864 F2d 648, 653-54 (9th Cir. 1988).

CGL policy itself.[91]

When faced with the insurer's argument that the business risk rationale supplanted exclusion L in its policy, the Minnesota Court of Appeals rejected it, stating:

> 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.*[92]

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 operation 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 or 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.[93]

And, in 2006, Texas courts still recognize this fact:

> Instead, the subcontractor exception demonstrates insurers intended to cover some defective construction resulting in damage to the insured's work.[94]

Further, as one common sense commentator summarized:

> The [insurance] industry has now taken to arguing that whenever a claim of defective construction is alleged against an insured, the claim is automatically barred from coverage as not constituting an "occurrence." The position is nothing more than a rehash of the "business risk" doctrine, whose success depends entirely on courts' ignoring the actual language of the CGL policy.[95]

Mr. O'Connor's words ring true here, and he is not alone.[96] The fallacy of the business risk rationale is best illustrated by a mistake made in an argument to the Court in *Lamar Homes*. In particular, Mid-Continent argued and the district court held that "if an insurance policy were to be interpreted as providing coverage for construction deficiencies, the effect would be to 'enable a contractor to receive initial payment for the work from the homeowner, then receive subsequent payment from his insurance company to repair and correct the defi-

[91] *See* J.S.U.B., Inc. v. United States Ins. Co., 906 So. 2d 303, 308 (Fla.App. 2005); *Lee Builders*, 104 P.3d at 1003; Wanzek Constr. Inc. v. Employers Ins. of Wausau, 679 N.W.2d 322, 326-28 (Minn. 2004); *Am. Family Mut.*, 673 N.W.2d at 83-84; Kvaerner Metals v. Commercial Union Ins. Co., 825 A.2d 641, 648-58 (Pa. 2003); Kalchthaler v. Keller Constr. 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); High Country Assocs. v. N.H. Ins. Co., 648 A.2d 474, 477-78 (N.H. 1994).

[92] *O'Shaughnessy*, 543 N.W.2d at 104-05 (emphasis added).

[93] 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 available by endorsement to broaden coverage over what was contained within the 1973 CGL policy).

[94] *Lennar Corp.*, 2006 WL 406609, at *10.

[95] James Duffy O'Connor, *What Every Construction Lawyer Should Know About CGL Coverage For Defective Construction*, 21-WTR CONSTR. LAW 15, 17 (2001).

[96] *See* Jotham D. Pierce, Jr., *Allocating Risk Through Insurance and Surety Bonds*, 425 PLI/REAL 193, 198-99 (1998) (noting that even courts that have regarded themselves as primary upholders of the "business risk" theory, denying coverage when possible, now recognize that the insurance industry *intended* to narrow the theory through the subcontractor exception). Interestingly, Mid-Continent and certain other CGL insurers have recently endorsed their policies to eliminate the subcontractor exception language to exclusion L. While Mid-Continent at oral argument argued that the new endorsement (CG 22 94) is being used to correct the misinterpretation of the subcontractor exception by certain courts, the expansive amount of case law and commentary discussing the evolution of the CGL policy proves otherwise. In particular, Mid-Continent's excuse for the adoption of CG 22 94 flies in the face of industry publications and other commentary that demonstrate that the insurance industry had made a purposeful decision to include coverage for general contractors for the defective workmanship of their subcontractors that caused damage to the project. *See Fireguard Sprinkler Sys.*, 864 P.2d at 651-54; *Am. Family Mut.*, 673 N.W.2d at 82-83; *Kvaerner Metals*, 825 A.2d at 656; APPLEMAN ON INSURANCE 2D, § 132.9; COUCH ON INSURANCE 3D, § 129:18.

ciencies in his own work.'"[97] The court of appeals that issued *T.C. Bateson*, however, recently noted that the principle quoted by Mid-Continent and the district court was based "solely on the 'business risk' exclusions, particularly the 'your work' exclusion. . . ."[98] The *Lennar Corp.* court went on to note that the version of the CGL policy at issue in *T.C. Bateson* did not have the subcontractor exception.[99] This point highlights the fact that the so-called "business risk" rationale is embodied, at least to some extent, in the carefully crafted business risk exclusions and thus, generally speaking, coverage should be won or lost by analyzing the applicability of the exclusions to the facts of a particular construction defect lawsuit.

B. THE CGL POLICY AS PERFORMANCE BOND ANOMALY

As a subset to its business risk rationale, insurers contend that a CGL policy is not a performance bond. While that statement undoubtedly is true, it does not necessarily follow that defective workmanship resulting in physical damage to the home itself runs contrary to the "property damage" and "occurrence" requirements in a CGL policy. While a performance bond and a CGL policy are two distinct things, the scope of protection provided by each is not necessarily mutually exclusive.[100]

This "argument" suffers from several infirmities. A performance bond is not insurance. The insurance policy is a contract of indemnity, while a surety bond is a guaranty of the performance of the principal's obligations. An insurance policy is issued based on an evaluation of risks and losses that is actuarially linked to premiums. In other words, losses are expected. In contrast, a surety bond is underwritten based on what amounts to a credit evaluation of the particular contractor and its capabilities to perform its contracts, with the expectation that no losses will occur. Sureties usually maintain close relationships with their contractor-principals as well as the contractor's bank, accountants and attorneys. As part of the underwriting of bonds, the surety analyzes the strengths and weaknesses of the contractor and its ability to perform its obligations. In short, the underwriting process is very similar to the process used by a lender in making a loan. In contrast to insurance, losses are not expected. In addition, the performance bond is not for the protection of the contractor, but rather for the protection of the owner (the "obligee"). If the contractor fails to complete its construction contract, the surety may satisfy its obligation to the obligee under the bond by providing additional financing so that the original contractor can complete the work, or by finding another contractor to complete the construction, or finally, by having the obligee complete the job itself, with the surety paying the extra costs.

The performance bond is a three-party instrument between the "obligee", the surety, and the contractor, with the surety retaining a right of indemnity against the contractor as well as other third-party indemnitors, typically the individual owners of a construction company. In the event of a claim, the surety will invoke the indemnity agreement with its principal (the contractor) and the indemnitors to hold it harmless and often to defend it against the claim. Thus, the contractor will, in effect, be required to pay the loss from its own funds when it indemnifies the surety. Of course, an insurance company has no right of indemnity against its insured, although it may seek to recover its losses from third parties through subrogation (or through an increase in premiums). Also, it is the liability insurer that bears the duty to defend claims alleged against its insured contractor if those claims arguably are covered under the policy. A surety owes no defense obligation to either its principal or the obligee. Courts have recognized the profound differences between performance bonds and liability insurance.[101]

Nevertheless, some claims, particularly claims that involve defective workmanship that cause damage to the project, can trigger ***both*** the CGL policy and the performance bond. In that instance, the CGL policy should respond, particularly in light of the contractor's indemnity obligations to the surety. Upon payment to the owner of a performance bond claim involving defective workmanship, the contractor's rights under its CGL policy are frequently assigned to the surety for pursuit of subrogation.[102]

[97] *Lamar Homes*, 335 F. Supp. 2d at 759 (quoting Jim Johnson Homes, Inc. v. Mid-Continent Cas. Co., 244 F. Supp. 2d 706, 714 (N.D.Tex. 2003) (in turn quoting T.C. Bateson Constr. Co. v. Lumbermens Mut. Cas. Co., 784 S.W.2d 692, 694-95 (Tex.App.—Houston [14th Dist.] 1989, writ denied)).

[98] *Lennar Corp.*, 2006 WL 406609, at *9.

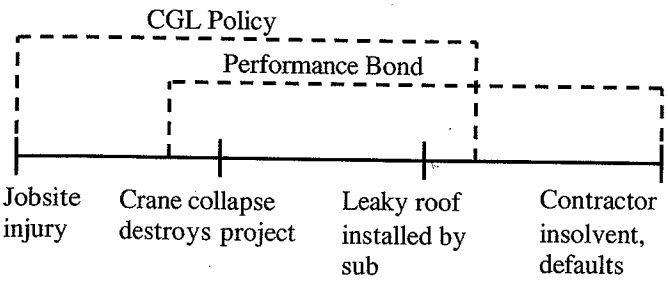
[99] *Id.*

[100] Mid-Continent also argued that if Lamar Homes' interpretation is accepted, general contractors will have little incentive to hire competent subcontractors, utilize proper materials and workmanship, or adhere to design and construction requirements. Not only is such an argument insulting to the very contractors that Mid-Continent seeks to insure, but it also is inaccurate. Lawyers, doctors, and other professionals have insurance that covers the consequences of our faulty work. It is hard to imagine a doctor leaving a sponge in a patient or a lawyer letting a statute of limitations run simply because insurance will take care of the consequences. Moreover, the insurance industry—through the underwriting process—is in the best position to handle any such issues. If a general contractor has a loss or repeated losses because of the hiring of incompetent subcontractors or failing to utilize proper materials and workmanship, the insurer can raise the premiums or non-renew the account.

[101] *See* Fidelity & Deposit Co. of Maryland v. Hartford Cas. Ins. Co., *supra* 189 F.Supp.2d 1212 (D.Kan. 2002); Cates Constr., Inc. v. Talbot Partners, 21 Cal.4th 28, 980 P.2d 407, 412 (Cal. 1999); Commercial Union Assurance Companies v. Gollan, 394 A.2d 839 (N.H. 1978); Lee Builders, Inc. v. Farm Bureau Mut. Ins. Co., *supra.*

[102] For cases illustrating the scenario of a performance bond surety having paid a claim, and then pursuing coverage for defective workmanship from its principal's CGL insurer, see Fidelity & Deposit Co. of Maryland v. Hartford, *supra;* Standard Fire Ins. Co. v. Chester-O'Donnelly & Assoc., Inc., 972 S.W.2d 1 (Tenn.App. 1998).

One of the undercurrents running through insurers arguments on this issue is that the scope of "coverage" of a performance bond and CGL policy must be mutually exclusive. While it is true that there are many types of risks and losses that fall within the ambit of a bond and not an insurance policy, and vice vesa, there remains a considerable overlap between the two. This is particularly true, where, as in the case of defective work, a breach of the bonded contract may be involved. In that connection, the following diagram can be considered:



This diagram illustrates a continuum of job-site risks.[103] Along that continuum, at the left are pure CGL policy losses, i.e., bodily injuries, and moving farthest to the right, a performance default by the contractor, a pure performance bond loss. Superimposed on that continuum is the scope of coverage provided by a CGL policy and a performance bond, signified by the dotted lines. As can be seen, there is an overlap in the middle. Starting at the left, assume that an accident at the job site seriously injures the employee of a subcontractor to the insured. In the event the insured contractor is sued by that employee, the contractor's CGL policy would respond to this claim. The performance bond is not implicated by the bodily injury. Next, assume a subcontractor's crane collapses, causing damage to major portions of the project. Absent a waiver of subrogation, the contractor's CGL policy may be required to respond to that loss. At the same time, the collapse and the attendant damage may constitute a breach of the general contractor's bonded contract, falling within the bonded obligation of the contractor, and thus the performance bond. Much the same can be said for a leaky roof installed by the roofing subcontractor on a project. Again, the contractor's CGL policy should respond to claims for property damage, even for the cost of repairing the roof itself based upon the subcontractor provision in the "your work" exclusion. Likewise, the roofing failure will constitute a breach of the bonded contract, thus implicating the performance bond. Finally, at the far right of the continuum is a classic default by the bonded contractor caused by insolvency. Such a default is a performance bond matter and should not impact liability coverage for the contractor as an insured. Thus, the diagram demonstrates that many claims, particularly defective work claims, may have a potential impact on both the performance bond and the CGL policy. The two seldom can be separated from each other where there is a breach of contract involving the work.

In *Kalchthaler v. Keller Constr. Co., supra,* 591 N.W.2d at 174, the Court recognized this overlap applying the subcontractor provision in Exclusion (l) to uphold coverage for claims against a general contractor for water damage to the interior of new construction caused by faulty window installation by a subcontractor. In the course of doing so, it stated as follows:

> For whatever reason, the [insurance] 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. [Citation omitted.] ...
>
> We have not made the policy closer to a performance bond for general contractors, the insurance industry has.

Once again, in reaching its conclusion, the Court concentrated on the language of the policy before it and not the insurer's overly simple argument that to grant coverage would "turn the CGL policy into a performance bond."[104]

C. THE "ECONOMIC LOSS" RULE DOES NOT NEGATE COVERAGE

Some insurers, particularly Mid-Continent, make a companion argument to the "business risk" rationale, contending that the economic loss rule negates coverage for damage caused by defective work under a CGL policy. Mid-Continent's argument requires two steps: (i) the court's application of the economic loss rule to negate tort claims pending in an underlying lawsuit; and (ii) the court's conclusion that a CGL policy does not apply to the remaining breach of contract/warranty claims. As a practical matter, these are exactly the two steps undertaken by the district court in *Lamar Homes.*

Numerous problems exist in undertaking this Texas two-step. First, it confuses a *liability* defense with a *coverage* defense. Second, any application of the economic loss rule when the underlying lawsuit still has tort claims pending in a different court would be nothing more than an advisory opinion that could lead to inconsistent rul-

[103]This diagram is excerpted from WIELINSKI, DEFECTIVE CONSTRUCTION, pp.289 - 290.

[104] For cases reaching a similar conclusion, *see,* O'Shaughnessy v. Smuckler Corp., *supra; Colony Dev. Corp.*, 736 N.E.2d at 947 (holding that the "performance bond" analogy is relevant to application of the business risk exclusions as opposed to the insuring agreement); *Lennar Corp.*, 2006 WL 406609, at *11 ("Finally, we reject the carriers' argument that allowing defective construction to constitute an "occurrence" will transform the CGL policy into a performance bond.").

ings. Third, even if the economic loss rule somehow applies, nothing in the CGL policy (let alone the "occurrence" and "property damage" definitions) speaks in terms of contract/warranty versus tort distinction. Fourth, Mid-Continent's "contort" analysis puts too much emphasis on the label of the cause of action.

Insurers support their economic loss rule argument by citing *Jim Walter Homes, Inc. v. Reed*, 711 S.W.2d 617 (Tex. 1986), and *Nobility Homes of Texas, Inc. v. Shivers*, 557 S.W.2d 77 (Tex. 1977), for the proposition that establishes that the damages sought in a defective construction lawsuit such as *Lamar Homes* are for purely economic losses that are not covered by a CGL policy. The words "insurance coverage," "occurrence," "accident," and "duty to defend" appear nowhere within those opinions. Simply put, neither *Jim Walter Homes* nor *Nobility Homes*, nor the cases that have followed them, have anything at all to do with insurance coverage—let alone with an insurer's duty to defend against allegations of faulty workmanship. In fact, the very first sentence of *Nobility Homes* states that "[t]his is a products liability case. It presents the question of whether a remote manufacturer is *liable* for the economic loss his product causes a consumer with whom the manufacturer is not in privity."[105] Similarly, the very first sentence of *Jim Walter Homes* states: "This case involves whether there is an independent tort to support an award of exemplary damages."[106] These cases obviously address *liability* issues—not coverage issues.

Insurers such as Mid-Continent also argue that no persuasive reason exists to analyze construction defect claims one way when insurance is not involved and another way when insurance is involved. In particular, they argue that the nature of the claim involved and the damages incurred do not change. While this may be true, liability and coverage have never been measured by the same yardstick. When determining whether the construction defect claim meets the "property damage" and "occurrence" definitions, the actual definitions used in the insurance policy control the analysis. It can hardly be argued that cracks in sheetrock and stone veneer do not constitute physical injury to tangible property. Stated otherwise, regardless of the label attached to the cause of action, the "physical injury to tangible property" requirement in the "property damage" definition has been satisfied. Neither *Jim Walter Homes* nor *Nobility Homes* changes this plain reading of the CGL policy.

Prior to the district court's opinion in *Lamar Homes*, at least one federal district court had rejected a similar attempt by Mid-Continent to apply the economic loss rule.[107] Subsequent to the district court's opinion in *Lamar Homes*, two Texas appellate courts rejected its application of the economic loss rule. In *Archon Investments*, for example, the Court noted as follows:

> Application of the economic loss doctrine of Jim Walter Homes would require us to extend the economic loss doctrine beyond the area of exemplary damages in an adjudicated case into the area of an insurance company's duty to defend on the pleadings (as the federal court did in Lamar Homes) and to subsume under Braden's breach of warranty claims both the torts that Braden has alleged Archon committed and the alleged torts of Archon's subcontractors, while ignoring the character of those claims. We decline to extend Jim Walter Homes as Great American requests.[108]

Likewise, in *Lennar Corp.*, the Court rejected the district court's application of the economic loss rule by noting that "the [Supreme Court] has not applied the economic loss doctrine to determine whether an insured's action constitutes an accident under a CGL policy."[109]

Courts from other jurisdictions similarly have rejected application of the economic loss doctrine to determine insurance coverage. The best example is the *American Family Mutual* case from the Wisconsin Supreme Court:

> The economic loss doctrine is a remedies principle. It determines how a loss can be recovered—in tort or in contract/warranty law. It does not determine whether an insurance policy covers a claim, which depends instead upon the policy language.[110]

[105] *Nobility Homes*, 557 S.W.2d at 77 (emphasis added).

[106] *Jim Walter Homes*, 711 S.W.2d at 617.

[107] *See Luxury Living*, 2003 WL 22116202, at *16 ("Thus, under controlling authority, Mid-Continent's assertion that the Wards' allegations do not fall within the scope of a commercial general liability policy and should be considered a business risk/economic loss to be borne by Luxury must be rejected.").

[108] 174 S.W.3d at 341. In so doing, the *Archon* court properly noted that the Supreme Court of Texas has recognized that "'[t]he contractual relationship of the parties may create duties under both contract and tort law' and that '[t]he acts of a party may breach duties in tort or contract alone or simultaneously in both.'" *Archon Investments*, 174 S.W.3d at 341 (quoting Jim Walter Homes v. Reed, 711 S.W.2d 617, 618 (Tex. 1986)).

[109] *Lennar Corp.*, 2006 WL 406609, at * 8.

[110] *Am. Family Mut.*, 673 N.W.2d at 75; *see also* Ferrell v. West Bend Mut. Ins. Co., 393 F.3d 786, 794-95 (8th Cir. 2005) (relying on *Am. Family Mut.* to reject application of the economic loss doctrine to determine insurance coverage); Commercial Union Ins. Co. v. Roxborough Village Joint Venture, 944 F. Supp. 827, 832 (D. Colo. 1996) (noting that the application of the economic loss doctrine in an insurance coverage case is improper). Commentators also agree with the view that the economic loss rule does not apply to insurance coverage. *See* 2 JEFFREY W. STEMPEL, LAW OF INSURANCE CONTRACT DISPUTES § 14A.02[d],14A.03[c]-[d], 14A.05[b] (2d ed. 1999 & Supp. 2005); BRUNER & O'CONNOR, at § 11.32; WIELINSKI, DEFECTIVE CONSTRUCTION, at 130-33.

The case law cited by Mid-Continent to the Texas Supreme Court illustrates its misapplication of the economic loss rule.[111] Notably, none of the economic loss rule cases cited by Mid-Continent has anything to do with insurance coverage. Rather, they amount to a string of cases that applied the economic loss rule to limit recovery in products liability cases. Mid-Continent fails to recognize that the product liability theories that form the basis of the economic loss rule have no application to the terms of an insurance contract. In particular, the definition of "your [Lamar Homes'] product" in the Mid-Continent policy extends to "any goods or products, *other than real property*, manufactured, sold, handled, distributed or disposed of by . . . You [Lamar Homes]." A house or commercial building is not a "product" and certainly qualifies as real property.[112]

In addition, asking a court in a coverage case to apply the economic loss rule to negate tort-based allegations in a pending underlying lawsuit results in an advisory opinion that may conflict with the trial judge's view in the underlying lawsuit.[113] Likewise, as the duty to defend standards make clear, it is improper for a coverage court to delve into the veracity of the underlying tort claims.[114] Even if it were true that the only viable claims asserted against Lamar sounded in contract/warranty, that fact is not dispositive of the coverage analysis for several reasons.

First, nothing in the definitions of "property damage" or "occurrence" sets forth any sort of "contort" distinction, with coverage provided for tort claims but not contract claims.[115] In fact, the words "negligence," "contract" or "warranty" do not appear in these definitions nor in any other portion of the insuring agreement. Certainly, if the insurance industry had intended to exclude coverage for breach of contract or breach of warranty claims, it could easily have done so through an explicit exclusion. Alternatively, it could have inserted the following language into the insuring agreement: "We will pay those sums that the insured becomes legally obligated to pay as damages [in tort] because of . . . 'property damage' to which this insurance applies."

Second, any contention 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."[116] Commentary from within the insurance industry supports this view as well. In particular, the Associate General Counsel of Kemper Insurance Companies noted that the "legally obligated to pay" clause that still exists in the insuring agreement of a CGL policy "is intentionally broad enough to include the insured's obligation to pay damages for breach of contract as well as for tort."[117]

Third, since the same act may constitute both a breach

[111] *See* Nobility Homes of Tex., Inc. v. Shivers, 557 S.W.2d 77 (Tex. 1977) (UCC implied warranty of merchantability as applied to manufactured mobile homes); Mid-Continent Aircraft Corp. v. Curry County Spraying Serv., Inc., 572 S.W.2d 308 (Tex. 1978) (rebuilt airplane bought "as is" with no implied warranties of merchantability and fitness); Two Rivers Co. v. Curtiss Breeding Serv., 624 F.2d 1242 (5th Cir. 1980) (loss of reputation of cattle herd as a result of genetically abnormal bull semen); Alcan Aluminum Corp. v. BASF Corp., 133 F. Supp. 2d 482 (N.D.Tex. 2001) (economic loss rule applied to manufacturer of urethane foam system); Rocky Mountain Helicopters, Inc. v. Bell Helicopter Co., 491 F. Supp. 611 (N.D.Tex 1979) (interpreting express or implied warranties applicable to helicopter crash).

[112] *See, e.g., Main Street Homes*, 79 S.W.3d at 697 (rejecting argument by insurer that a completed home was the insured's product); *Mid-United Contractors*, 754 S.W.2d at 826-27 (rejecting contention of insurer that construction project is the insured's "product").

[113] By way of example, the DiMares' lawsuit in state court had pending tort claims against Lamar Homes at the time that Judge Yeakel ruled that the economic loss rule applied. Although the DiMares' lawsuit was settled prior to any ruling by the trial court as to the application of the economic loss rule, it is possible that the trial judge would have disagreed with Judge Yeakel as to the viability of the tort claims. The potential for conflicting opinions—regardless of which judge is correct—demonstrates why coverage courts should not be permitted to rule on liability defenses while the underlying lawsuit is still pending.

[114] *See Archon Investments*, 174 S.W.3d at 341-42 (rejecting a CGL insurer's invitation to attack the veracity of the tort allegations at the duty to defend stage); *Gehan Homes*, 146 S.W.3d at 842-43 (same). Under Texas law, a determination on the ultimate issue of negligence need not be made in order to invoke an insurer's duty to defend. Rather, an underlying lawsuit must only allege facts for which a potential for coverage exists. *See Steve Roberts Custom Builders*, 215 F. Supp. 2d at 788; *Main Street Homes*, 79 S.W.3d at 694-95.

[115] *See* Essex Builders Group, Inc. v. Amerisure Ins. Co., 2005 WL 3981766 (M.D. Fla. Sept. 21, 2005) (noting that the determination of coverage was dependent on whether there had been an occurrence of property damage as opposed to whether the claims sounded in tort or contract); Am. Family Mut. Ins. Co. v. Am. Girl, Inc., 673 N.W.2d 65, 77-78 (Wis. 2004); Vandenberg v. Superior Court, 982 P.2d 229, 245 (Cal. 1999); Broadmoor Anderson v. Nat'l Union Fire Ins. Co., 912 So. 2d 400, 405 (La.App. 2005); BRUNER & O'CONNOR, at § 11.36; WIELINSKI, DEFECTIVE CONSTRUCTION, at 19-31.

[116] *See* SCOTT C. TURNER, INSURANCE COVERAGE FOR CONSTRUCTION DISPUTES § 6.8 (2d ed. 2003) ("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 . . . .").

[117] See George H. Tinker, Comprehensive General Liability Insurance—Perspective and Overview, 25 FED. INS. COUN. Q. 217, 265 (1975).

[118] *See* Ins. 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."); E&R Rubalcava Constr., 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); Stumph v. Dallas Fire Ins. Co., 34 S.W.2d 722 (Tex.App.—Austin 2000, no. pet.) (noting that coverage would not be precluded if the contractor's breach of contract or warranty resulted from an accident within the meaning assigned to it in the insurance policy); *see also* Vandenberg v. Centennial Ins. Co., 982 P.2d 229, 243-46 (Cal. 1999) (overruling a long line of California case law that had supported the contract versus tort distinction for purposes of determining insurance coverage); Broadmoor Anderson v. Nat'l Union Fire Ins. Co., 912 So. 2d 400, 405 (La.App. 2005) ("This policy language for the CGL grant of coverage does not make any express distinction between tort or contractual liability. While the term 'accident' may imply a tortious event, T-Z's deficient conduct, unexpected and with lack of foresight, can also be considered accidental."); *Am. Family Mut.*, 673 N.W.2d at 78 ("If, as American Family contends, losses actionable in contract are never CGL 'occurrences' for purposes of the initial coverage grant, then the business risk exclusions are entirely unnecessary."); Amerisure Mut. Ins. Co. v. Paric Corp., 2005 WL 2708873 (E.D. Mo. Oct. 21, 2005), *appeal pending* ("The ESA defendants have asserted negligence claims against defendant Paric in two of the underlying actions where a subcontractor installed the EIFS. In the remaining action, defendant Paric apparently installed the EIFS itself and no negligence claim was asserted against defendant Paric. However, the Court does not find that these differences rule out the possibility of plaintiff's coverage in any of the underlying actions.") .

of contract and a tort, drawing a coverage line between the two is a distinction without a difference.[118] In fact, aside from the availability of attorneys' fees under a breach of contract theory, it is quite possible that the measure of recovery under tort versus contract would be the same or very similar.

Fourth, both the Supreme Court of Texas and the Fifth Circuit have recognized that intentional and negligent types of tortious acts occur in the performance of a contract.[119] Thus, the mere fact that construction duties originally flowed from a contract does not alter the coverage analysis in any manner.

Mid-Continent also relied, in part, on *Hartrick v. Great American Lloyd's Insurance Company*, 62 S.W.3d 270 (Tex. App.—Houston [1st Dist] 2001, no pet.), to bolster its argument that a *breach of warranty* claim is not covered by a CGL policy. In addition to the fact that the court that issued *Hartrick* retreated somewhat from its narrow stance in *Archon Investments, Inc. v. Great American Lloyds Insurance Company*, 174 S.W.3d 334 (Tex. App.—Houston [1st Dist.] 2005, pet. filed) (a panel that included the author of *Hartrick*), the holding that a breach of warranty cannot constitute an "occurrence" is questionable for the same reasons as set forth above in connection with breach of contract. Simply put, the insuring agreement of a CGL policy makes no distinction based on the particular cause of action pled. Moreover, when adopting the implied warranty cause of action, the Supreme Court of Texas noted that service providers such as homebuilders could absorb the cost of fulfilling such warranties through insurance.[120] Additionally, the Supreme Court of Texas has not articulated a distinction between a claim of negligence sounding in tort and a claim for breach of implied warranty that would justify an across-the-board coverage difference between the two.[121] Assuming this to be the case, why should any discernable difference exist for purposes of the coverage analysis?

The entire "contort" distinction places inappropriate emphasis on the label of the cause of action rather than on the substance of the claim. In this regard, Mid-Continent took inconsistent positions before the Court. On the one hand, Mid-Continent contends that the negligence claim can simply be ignored and that courts should focus instead on the origin of the damages. On the other hand, after applying its economic loss defense, Mid-Continent argues that CGL policies do not cover breach of contract or breach of warranty claims. Contrary to that argument, the label of the cause of action—whether it is negligence, contract, or warranty—simply does not control the coverage analysis. That being said, Lamar Homes did not contest the viability of the economic loss rule as applied in underlying construction defect claims. Rather, many types of damage arising out of defective work still satisfy the definitions of "property damage" and "occurrence" even if the damage is not actionable in tort. The insured contractor is entitled to coverage for the portion of those damages that are not otherwise excluded by the CGL policy.

Moreover, if an owner can only assert claims of breach of contract and/or breach of warranty against a general contractor for damage to the work itself, and if such claims can never give rise to an "occurrence" in the first place, then the business risk exclusions in the policy serve no purpose. In other words, no need would exist for the "your work" exclusion because any construction defect claim for property damage to the work itself, to which the exclusion would apply, would already run afoul of the policy's "occurrence" requirement.[122] Of course, if Mid-Continent is correct, it and other like-minded CGL insurers are guilty of a classic bait-and-switch.

VI. A Middle Ground?

Insured contractors contend that physical damage to the work itself can be "property damage" caused by an "occurrence," so long as the damage is unexpected or unintended from the standpoint of the insured. Moreover, at least in the completed operations context, such a loss is not excluded because of the explicit subcontractor exception language to exclusion L. Insurers, on the other hand, argue that physical damage to the work itself is inherently foreseeable due to the general contractor's contractual undertaking and thus is not an "occurrence." Similarly, they argue that damage to the

[119] *See Grapevine Excavation*, 197 F.3d at 729-30.

[120] *See* Melody Home Mfg. Co. v. Barnes, 741 S.W.2d 349, 353 (Tex. 1987).

[121] *See* Humber v. Morton, 426 S.W.2d 554, 556 (Tex. 1968) ("[T]he notion of implied warranty arising from sales is considered to be a tort rather than a contract concept"); Coulson & Cae, Inc. v. Lake L.B.J. Mun. Util. Dist., 734 S.W.2d 649, 651 (Tex. 1987) (noting that no real difference exists between claim for breach of implied warranty and negligence).

[122] Mid-Continent's conduct toward other parties to the DiMares' lawsuit highlights the fallacy of its position. Mid-Continent, in addition to insuring Lamar Homes (the general contractor), also insured the foundation subcontractor. Mid-Continent, in fact, defended and indemnified the foundation subcontractor against the allegations in the DiMares' lawsuit. Mid-Continent's actions in defending and indemnifying the foundation subcontractor are completely consistent with its view that coverage must be analyzed in connection with the insured's contractual undertaking. In particular, under Mid-Continent's theory, the cracks in the sheetrock and stone veneer would constitute "property damage" caused by an "occurrence" as to the foundation subcontractor since those damages were to property other than to the foundation that was the subject matter of the subcontractor's contract. In stark contrast, as to Lamar Homes (the general contractor), those ***same*** cracks in the ***same*** sheetrock and stone veneer no longer are considered "property damage" caused by an "occurrence" because Lamar Homes contracted for the construction of the entire house. In other words, under this view, the subcontractor that performs the allegedly faulty work that causes damage should be provided with a defense and indemnity whereas the general contractor that gets sued for the exact same damages because of its contractual privity with the owner should be deprived of a defense and indemnity. In the context of *Lamar Homes*, it makes no sense to cover the foundation subcontractor for the physical damage to the home, while at the same time denying coverage to the general contractor for the same damages.

work itself is a mere economic loss that does not satisfy the definition of "property damage." As for the subcontractor exception language, insurers contend that exceptions to exclusions cannot create coverage if none exists.

As can be seen, these arguments, all made by the two parties in *Lamar Homes* are at polar opposites.[123] Nevertheless a middle ground approach is found in two recent cases. In *Okatie Hotel Group, LLC v. Amerisure Ins. Co.*, 2006 WL 91577 (D. S.C. Jan. 13, 2006), for example, a federal district judge was faced with analyzing a recent Supreme Court decision from South Carolina. The Supreme Court decision had reversed a widely-cited appellate court decision that had supported coverage for construction insureds.[124] The South Carolina Supreme Court's opinion, which was at least initially perceived as a major blow to insureds, held that damage to the insured's work product is not accidental and thus not an occurrence.[125]

The *Okatie* court, however, was troubled by the fact that the *L-J* court cited with approval to cases that seemingly stood for the opposite proposition. In particular, in *L-J*, the South Carolina Supreme Court noted that it found the New Hampshire Supreme Court's analysis in *High Country Associates v. New Hampshire Insurance Company*, 648 A.2d 474 (N.H. 1994), helpful "in distinguishing a claim for faulty workmanship versus a claim for damage to the work product caused by the negligence of a third party."[126] In the *High Country* case, the New Hampshire Supreme Court upheld coverage for a general contractor for damage to a building caused by the exposure to water seeping into the negligently constructed walls. In particular, the *High Country* court concluded that the claimant had "alleged negligent construction that resulted in an occurrence, rather than an occurrence of alleged negligent construction."[127]

Ultimately, based on *L-J's* approval of *High Country,* the *Okatie* court concluded that *L-J* merely stood for the proposition that no "occurrence" exists if the damage is restricted to the defect itself. According to the *Okatie* court, the *L-J* court found no coverage because the negligent acts in connection with the construction of the roadway system resulted only in damage to the roadway system.[128] The *Okatie* court then proceeded to distinguish *L-J* based on the facts before it. In *Okatie*, the general contractor contracted to construct a 66-room Fairfield Inn Marriott. It was alleged that, following completion, the hotel was exposed to leaks and moisture infiltration. In other words, there was "property damage beyond damage to the work product and/or the improper performance of the task itself."[129] The *Okatie* court was not concerned with the fact that the entire hotel was the work product of the general contractor. Rather, the *Okatie* court was only concerned with whether the damage extended beyond the defect itself to otherwise nondefective work.

More recently, and also in the face of a seemingly bad decision from a state supreme court, the Fourth Circuit adopted this middle-ground approach.[130] James and Kathleen French contracted with Jeffco Development Corporation for the construction of a single-family home. Pursuant to the construction contract, and through the use of a subcontractor, the exterior of the home was clad with EIFS. Following completion of the home, the Frenches discovered extensive moisture and water damage to the otherwise nondefective structure and walls of their home resulting from the defective EIFS cladding. The parties made the same arguments as those before the Court in *Lamar Homes*. The Fourth Circuit, however, adopted the middle-ground:

> We hold that . . . a standard 1986 commercial general liability policy form published by ISO does not provide liability coverage to a general contractor to correct defective workmanship performed by a subcontractor. We also hold that . . . the same policy form provides liability coverage for the cost to remedy unexpected and unintended property damage to the contractor's otherwise nondefective work-product caused by the subcontractor's defective workmanship.[131]

In other words, the Court held that damage to the defective EIFS itself is not an "occurrence" whereas the physical damage *caused by* the defective EIFS to otherwise nondefective parts of the home is an "occurrence".[132] In reaching this holding, the Fourth Circuit specifically recognized that the coverage distinctions such as espoused by Mid-Continent in the *Lamar Homes* case are without merit:

> At oral argument, counsel for Insurance Defendants candidly and correctly acknowl-

[123] The *Lennar Corp.* case from the Houston Court of Appeals and the recent *Grimes Construction* case from the Fort Worth Court of Appeals are good examples of the competing interpretations of the CGL policy.

[124] *See* L-J, Inc. v. Bituminous Fire & Marine Ins. Co., 621 S.E.2d 33 (S.C. 2005) (opinion on reh'g).

[125] *Id.* at 36.

[126] *L-J*, 621 S.E.2d at 36.

[127] 648 A.2d at 478.

[128] *Okatie*, 2006 WL 91577, at *6.

[129] *Id.*

[130] *See* French v. Assurance Co. of Am., 2006 WL 1099471 (4th Cir. Apr. 27, 2006).

[131] *French*, 2006 WL 1099471, at *11.

[132] *See Id.* at *8.

> edged that had a portion of the defective EIFS exterior on the Frenches' home fallen outwardly onto an automobile or inwardly onto a painting hanging on an interior wall or on furniture in the home, the 1986 ISO CGL Policies would have provided Jeffco liability coverage for damages to the automobile, the painting, and the furniture. In this same vein, it is illogical to contend that had the defective EIFS exterior on the Frenches' home failed and caused damage to the flooring inside the home or to the structural members of the house, neither of which was defective at completion of construction and certification of occupancy, coverage would not have been provided under the 1986 ISO CGL Policies.[133]

The authors do not advocate this "middle ground" approach because it still reads something into the CGL policy that simply is not there (i.e., a requirement of damage beyond the work itself). As such, it represents a departure from the language of the policy and usually, nothing good comes from freelancing the policy language. For example, under the language of the exception to exclusion L, the policy provides coverage for even the defective portion of the work, as long as a subcontractor's work is involved. Even in the operations context, under exclusions J(5) and J(6), additional coverage may be available through the "particular part" limitation.[134]

Even so, if the Supreme Court of Texas were to adopt the middle-ground approach, it would require affirmative answers to the first two certified questions. In particular, as applied to *Lamar Homes*, the allegations of cracks to the stone veneer and sheetrock are certainly damages that extend beyond the alleged defects in the foundation. Moreover, as the fact patterns of *Okatie* and *French* demonstrate, negative answers to the first two certified questions in *Lamar Homes* would effectively eliminate coverage for risks that clearly fall within the coverage afforded by the CGL policy.

VII. Conclusion

Decades ago, the Supreme Court of Texas stated that a court "must presume that the objective of the insurance contract is to insure, and [courts] should not construe the policy to defeat that objective unless the language requires it."[135] What the Supreme Court of Texas said in *Goswick* is as true today as it was in 1969. Nothing in the "occurrence" and "property damage" definitions supports the conclusion that defective construction by a general contractor that results in inadvertent damage to the work itself do not fall within the insuring agreement of the CGL policy. Quite to the contrary, the presence of carefully crafted construction-specific exclusions and the exceptions to those exclusions establish that the CGL policy was in fact intended to cover such claims in certain circumstances.

The arguments against coverage in the *Lamar Homes* case, and other cases that came before it, are little more than a revisionist approach to CGL coverage for defective construction. Moreover, by presenting their arguments in isolation from the actual policy language, insurers like Mid-Continent attempt to avoid or circumvent the effect of carefully drafted policy exclusions. Those exclusions, in fact, place express limits on the general notion that a CGL policy does not cover a general contractor's risk of defective work by its subcontractors in the context of completed operations. Accordingly, the success of these arguments rests on a truncated analysis of the CGL policy.

Although the courts in Texas and across the nation have issued diverging opinions, the better reasoned authorities support coverage in cases such as *Lamar Homes*. Only time will tell if the Supreme Court of Texas agrees with Lamar Homes, Mid-Continent, some sort of middle ground, or another approach to these thorny issues.

[133] *Id.* at *10.

[134] For a discussion of these exclusions, *see* Wielinski, Defective Construction, chs. 9 and 10.

[134] Goswick v. Employers' Cas. Co., 440 S.W.2d 287, 289 (Tex. 1969).

APPENDIX

Summit Custom Homes, Inc. v. Great Am. Ins. Co., 2006 WL 1985964 (Tex. App.—Dallas July 18, 2006, no pet. h.)	
Pine Oak Builders, Inc. v. Great Am. Lloyds Ins. Co., Cause No. 14-05-00487-CV (Tex. App.—Houston [14th Dist. July 6, 2006, no pet. h.)	
Lennar Corp. v. Great Am. Ins. Co., 2006 WL 406609 (Tex. App.—Houston [14th Dist.] Feb. 23, 2006 pet. filed.) (not designated for publication)	*Grimes Construction, Inc. v. Great Am. Lloyds Ins. Co.*, 2006 WL 563286 (Tex. App.—Fort Worth Mar. 9, 2006, pet. filed)
Home Owners Mgmt. Enters. v. Mid-Continent Cas. Co., 2005 WL 2452859 (N.D. Tex. Oct. 3, 2005)	*Courtland Custom Homes, Inc. v. Mid-Continent Cas. Co.*, 395 F. Supp. 2d 478 (S.D. Tex 2005)
Archon Invs., Inc. v. Great Am. Lloyds Ins. Co., 174 S.W.3d 334 (Tex. App.—Houston [1st Dist.] 2005, pet. filed)	*Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 335 F. Supp. 2d 754 (W.D. Tex. 2004)
Mid-Continent Cas. Co. v. JHP Dev., Inc., 2005 WL 1123759 (W.D. Tex. Apr. 21, 2005)	*Vesta Fire Ins. Co. v. Nutmeg Ins. Co.*, No A-00-CA-468-SS (W.D. Tex., Sept. 29, 2003) (not designated for publication)
Gehan Homes, Ltd. v. Employers Mut. Cas. Co., 146 S.W.3d 833 (Tex. App.—Dallas 2004, pet. filed)	*Mid-Arc, Inc. v. Mid-Continent Cas. Co.*, 2004 WL 1125588 (W.D. Tex. Feb. 25, 2004)
Luxury Living, Inc. v. Mid-Continent Cas. Co., 2003 WL 22116202 (S.D. Tex. Sept. 10, 2003)	*Jim Johnson Homes, Inc. v. Mid-Continent Cas. Co.*, 244 F. Supp. 2d 706 (N.D. Tex. 2003)
Great Am. Ins. Co. v. Calli Homes, 236 F. Supp. 2d 693 (S.D. Tex. 2002)	*Acceptance Ins. Co. v. Newport Classic Homes, Inc.*, 2001 WL 1478791 (N.D. Tex. 2001)
CU Lloyd's of Texas v. Main Street Homes, Inc., 79 S.W.3d 687 (Tex. App.—Austin 2002, no pet.)	*Hartrick v. Great Am. Lloyds Ins. Co.*, 62 S.W.3d 270 (Tex. App.—Houston [1st Dist.] 2001, no pet.)