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The Case Law Catch-All:
What Else Happened?

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RECENT CASES

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

A. Background Facts

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

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

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

B. The Certified Questions

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

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

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

At the outset, the Court acknowledged that insurance policies are contracts and that it must effectuate the parties' expressed intent. In doing so, it enforces such contracts as written, so long as the language is unambiguous. If, however, such language is ambiguous, it is construed in favor of coverage. In light of such principles, the court turned to the relevant language in the OneBeacon policies, which provided as follows:

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

Id. at 23–24. The policies further provide:

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

Id. at 24. The policy defines an "occurrence" as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions." *Id.* And, finally, "property damage" is defined as follows:

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

Id.

Looking at those provisions, and giving them their plain meaning, the Court held that property damage occurred when actual physical injury to the property at issue occurred. That is, property damage occurs at the time when a home that is the subject of an underlying lawsuit suffers wood rot or other physical damage. The Court found this to be true regardless of the date that the physical damage was or could have been discovered. The date of discovery, according to

the Court, "is irrelevant." *Id.* In other words, the Court adopted what other courts have called the "actual injury" or "injury-in-fact" approach by which an insurer must defend any claim of physical property damage that occurred during the policy period. *Id.* at 25.

In adopting that trigger theory, the Court recognized the varying approaches adopted by other courts and the Fifth Circuit's note that the issue has not been uniformly resolved in Texas and across the country. *Id.* at 25–26. In particular, as it had long been the majority rule in Texas, the Court primarily discussed the "manifestation rule" that imposes a duty on an insurer only if property damage became evident or readily identifiable during the insurer's policy period. *Id.* at 26. The Court noted, though, that even the manifestation trigger has variations with some courts requiring actual discovery and others looking to when the damage *could have been* discovered. And, even then, courts taking the latter approach varied as to how easily discoverable the damage must be to trigger a duty to defend. *Id.* at 27. Importantly, the court discussed decisions in which courts use the word "manifest" and have been cited as adopting the manifestation rule even though such cases did not deal with *latent* property damage—the point at which the manifestation and the injury-in-fact trigger diverge. *Id.* The Court concluded that such cases actually can be read as adopting the same injury-in-fact trigger it adopted, and that their use of the word "manifest" is used as a synonym for "results in," "rather than [for] drawing a distinction between the actual occurrence of damage and the later discovery or obviousness of damage." *Id.*

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

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

Taking a literal approach to the policy language, the Court explained that "[t]his policy links coverage to damage, not damage detection." *Id.* And, by applying the manifestation rule, the Court was concerned that the line between occurrence-based and claims-made policies would be blurred. In any event, the Court noted that had insurers wanted a policy where coverage de-

pends on manifestation of damage, then insurers could adopt such a policy and seek its approval from Texas insurance regulators. *Id.* Moreover, despite OneBeacon's claim that the manifestation rule is easier to apply, the Court said that it "does not eliminate the need to address sometimes nettlesome fact issues." *Id.* For example, at least one version of the manifestation rule requires proof not of when the claimant actually identified the damage, but when it was *capable* of such identification. *Id.* In that case, the injury-in-fact rule may be just as easy—if not easier—to apply than the manifestation rule.

Further, in addressing the "ease of application" argument, the Court recognized that pinpointing the moment of injury retrospectively can be difficult in some cases, "but we cannot exalt ease of proof or administrative convenience over faithfulness to the policy language; our confined task is to review the contract, not revise it." *Id.* In addition, the Court found that its holding was consistent with scholarly authority. *Id.* at 30 (citing 7A JOHN ALAN APPELMAN, INSURANCE LAW AND PRACTICE § 4491.01 (Walter F. Berdal ed., 1979); 7 COUCH ON INSURANCE § 102.22)). As explained in Couch on Insurance, "the manifestation rule 'obviously gives short shrift to the specific terms inserted in the policy to address the risk exposure.'" *Id.* According to the Court, though, Texas law does not. *Id.* In closing its discussion of the first certified question, the Court made clear that it was not adopting a blanket rule for all CGL policies; instead, it held that an insurer's duty to defend should be determined by the language in the insurance policy, which can vary from one policy to another. *Id.*

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

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

D. The Aftermath

A month after the Supreme Court of Texas' decision in *Don's Building*, the Dallas Court of Appeals applied the decision in another case involving the same company. *See Union Ins. Co. v. Don's Building Supply, Inc.*, 266 S.W.3d 592 (Tex. App.—Dallas 2008, pet. denied). In that case, the appellate court applied the Supreme Court's ruling and found that Union Insurance owed Don's Building a defense under their 1996, 1997 and 1998 insurance policies. *Id.* at 595.

Notably, that court also rejected the insurer's contention that the policies were not triggered because the claimants did not own the home at issue during those policy periods. *Id.* In doing so, the appellate court stated: "While ownership of the home was not an issue in *OneBeacon*, we do not believe this distinction warrants departure from the supreme court's analysis." *Id.* at 596.

The Dallas Court of Appeals again addressed the trigger issue in *Thos. S. Byrne, Ltd. v. Trinity Universal Insurance Co.*, 2008 WL 5095161 (Tex. App.—Dallas Dec. 4, 2008, no pet.). There, the appellate court reversed the trial court's grant of summary judgment in favor of the insurers, finding that the insurers owed a defense to their additional insured, Thos. S. Byrne. Notably, Thos. S. Byrne was the general contractor on the project and sought coverage under its subcontractors' insurance policies as an additional insured. The subcontractors were not named as defendants, but they were referenced by name in the allegations against Thos. S. Byrne.

The trial court had denied a duty to defend because the additional insured endorsements were limited to "ongoing operations" and the pleading against Thos. S. Byrne suggested that the damage was *discovered* after completion of the project. In reversing the trial court's decision, the court of appeals noted that the insurance policies at issue contained identical "occurs during the policy period" language as that in *Don's Building Supply*, and thus it was obligated to apply the "injury-in-fact" rule announced therein. As such, the court found two allegations in the underlying pleading, which were relied on by the trial court, to be "irrelevant" because they addressed when the owner discovered property damage or when it became manifest. *Id.* at *7. The court of appeals then liberally applied Texas' "eight corners" rule, analyzing each of the remaining allegations and finding that open-ended claims of the occurrence of damage created the potential for damage during ongoing operations. As such, a defense was owed to Thos. S. Byrne as an additional insured.

Other courts also have utilized the Court's analysis in *Don's Building Supply*. *See Wilshire Ins. Co. v. RJT Constr., LLC*, 2009 WL 2605436 (5th Cir. Aug. 26, 2009) ("The cracks are not merely a warning of prior undiscovered damage; they are the damage itself. It is of no moment that the faulty foundation work occurred in 1999 or that the damage was discovered in 2005; it matters only that damage was alleged to have occurred in 2005."); *Pine Oak Builders, Inc. v. Great Am. Lloyds Ins. Co., Ltd.*, 279 S.W.3d 650 (Tex. 2009) (adhering to its holding in *Don's Building Supply*, and remanding to the trial court so that the "actual injury" rule could be applied and a determination made as to whether the property damage claims at issue fell within the terms of Great American's insurance policies); *Vines-Herrin Custom Homes, LLC v. Great Am. Lloyds Ins. Co.*, 44th Judicial District Court (Dallas Co.) (Aug. 7, 2009) (holding that an insured's failure to present expert testimony as to when damages at a home *actually occurred* instead of when they were *discovered* foreclosed recovery by the insured and resulted in a take-nothing judgment against the insured and the injured third party).[1] *See also Central Mut. Ins. Co. v. KPE Firstplace Land, LLC*, 271 S.W.3d 454 (Tex. App.—Tyler 2008, no pet.) (finding that an insurer had not met its burden regarding application of an exclusion utilizing the word "occurs" because the insurer could not show that the damage at issue occurred after the building had been vacant for more than sixty days only that it manifested at that time).

[1] Although only a trial court decision, the *Vines-Herrin Custom Homes* case highlights the difficulty that may occur in applying an injury-in-fact trigger.

Commentary:

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

The opinion undoubtedly will result (and already has) in a change as to how insurance carriers approach property damage claims—especially in the context of construction defect claims. Most, if not all, insurance carriers assumed that Texas was a manifestation state—at least for "property damage" claims.[2] Now, that assumption is no longer valid and insurers will have to re-examine their obligations to respond to "property damage" claims. An insurer, by way of example, can no longer deny coverage simply because the underlying claimant invokes the discovery rule. Similarly, an insurer can no longer deny coverage simply because the underlying claimant alleges "discovery" of the damage after the insurer's policy period has expired.

Even so, the Court's opinion left open some important issues. For example, the Court did not address what would happen in circumstances where the property damage occurred in the course of a continuing process—but began before the inception of the term of the policy at issue. Likewise, in declining to address the duty to indemnify, the Court left open the issue of how insurers will adjust losses where property damage begins during the policy period but continues into other policy periods. Further, the Court did not address the quantum of proof necessary in order to establish actual injury within a policy period.

Most likely, although not explicitly discussed, the injury-in-fact trigger will result in more frequent application of the "known loss" or "loss in progress" doctrines as well as application of specific policy language dealing with continuous losses that was incorporated into standard ISO forms in 2001 (f/k/a the "Montrose Endorsement").[3] The opinion likely also will result in a lively debate as to whether Texas follows an "all sums" approach to allocation or whether losses should be pro-rated—and, if so, how—among consecutively triggered policies. Finally, the Court was careful to limit its holding to the specific policy language before it. Accordingly, when dealing with manuscript forms, it will be important to carefully review the policy language before assuming that an injury-in-fact trigger applies. Simply put, while *Don's Building Supply* may have answered the trigger issue, it has left many unanswered issues that undoubtedly will lead to coverage litigation and ultimately more opinions from the Supreme Court of Texas.

II. *Mid-Continent Casualty Co. v. JHP Development, Inc.*, 557 F.3d 207 (5th Cir. 2009)

[2] The Court declined to address which trigger applies to "bodily injury" claims. Moreover, the "injury-in-fact" trigger has been rejected for Coverage B cases. *See Trammell Crow Residential Co. v. Virginia Surety Co.*, 2008 WL 5062132 (N.D. Tex. Dec. 1, 2008) (refusing to apply the "injury-in-fact" trigger theory to a Coverage B claim because the policy specified that the "offense" take place during the policy period);

[3] The policies at issue in *Don's Building Supply* pre-dated the so-called *Montrose* language.

On January 28, 2009, the Fifth Circuit Court of Appeals issued an opinion clarifying the scope of exclusions J(5) and J(6) of the standard CGL insurance policy. *See Mid-Continent Cas. Co. v. JHP Development, Inc.*, 557 F.3d 207 (5th Cir. 2009). In doing so, the Fifth Circuit affirmed the Western District of Texas' opinion in which it was found that Mid-Continent owed its insured, JHP Development, a defense and indemnity for damages awarded to TRC Condominiums, Ltd. in a state court lawsuit between JHP and TRC, stemming from JHP's defective construction of a condominium project in San Antonio. In reaching its decision, the Fifth Circuit rejected Mid-Continent's claim that J(5) applied because four of the five condominiums in the project were left unfinished. Turning to J(6), the court held that the "that particular part" language must mean something under Texas law, and thus the exclusion did not bar coverage for damage to otherwise non-defective portions of the condominiums. Finally, the Fifth Circuit applied the Supreme Court of Texas' decision in *Evanston Insurance Co. v. ATOFINA Petrochemicals, Inc.*, 256 S.W.3d 660 (Tex. 2008), and held that Mid-Continent was bound by the default judgment awarded to TRC against JHP in the underlying lawsuit.

A. Background Facts

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

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

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

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

Mid-Continent then filed a declaratory judgment action against JHP and TRC, seeking a declaration that (1) JHP was not entitled to coverage; (2) no defense or indemnity duties existed; (3) TRC was not entitled to recover any sums as a third-party beneficiary or judgment creditor; and (4) the default judgment was not binding on Mid-Continent. JHP never filed an answer in the

declaratory judgment action. TRC, in contrast, filed a counterclaim against Mid-Continent. Mid-Continent and TRC ultimately filed cross-motions for summary judgment on the coverage issues in the district court. That court granted TRC's motion and denied Mid-Continent's. The Western District of Texas ruled that there was an "occurrence" and "property damage," none of the exclusions applied to bar coverage and the default judgment in the underlying suit was binding on Mid-Continent.

On appeal, Mid-Continent abandoned its argument regarding the lack of an "occurrence" or "property damage" in light of the Supreme Court of Texas' opinion in *Lamar Homes, Inc. v. Mid-Continent Casualty Co.*, 242 S.W.3d 1 (Tex. 2007). Instead, the insurer urged the appellate court to find that exclusions J(5) and J(6) barred coverage and that, in any event, the default judgment against its insured was not binding on Mid-Continent because there was not a fully adversarial trial.

B. The Exclusions

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

This insurance does not apply to:

***

j. Property damage to:

***

(5) That particular part of real property on which you or any contractor or subcontractors working directly or indirectly on your behalf are performing operations, if the 'property damage' arises out of those operations; or

(6) That particular part of any property that must be restored, repaired or replaced because "your work" was incorrectly performed on it.

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

As recognized by the Fifth Circuit, both J(5) and J(6) are known as "business risk" exclusions, "designed to exclude coverage for defective work performed by the insured." *JHP*, 557 F.3d at 211. Moreover, unlike exclusion L which applies to completed operations, both J(5) and J(6) apply to damages that occur during the course of construction.

1. Exclusion J(5)

After explaining the applicable legal standards under Texas law for interpreting exclusions, the court turned to the applicability of the exclusions to the facts at hand. With respect to J(5), the parties were in agreement that "the use of the present tense 'are performing operations'" in the exclusion clarifies that the exclusion applies only to property damage that occurred during

the performance of JHP's construction operations. The parties, however, disagreed as to whether JHP was "performing operations" when the water intrusion took place. TRC argued that JHP was not "performing operations" because construction had been suspended until the four units were purchased. Mid-Continent, on the other hand, claimed that the project involved ongoing construction because the units remained unfinished.

Citing *Lamar Homes* and *CU Lloyd's of Texas v. Main Street Homes*, 79 S.W.3d 687 (Tex. App.—Austin 2002, no pet.), as well as *The Oxford English Dictionary*, the court explained that "performing operations" means "the active performance of work." According to the court, "[t]he prolonged, open-ended, and complete suspension of construction activities pending the purchase of the condominium units does not fall within the ordinary meaning of 'performing operations.'" Further, "[a]lthough JHP intended to eventually complete construction work once the units were sold, an actor is not actively performing a task simply because he has not yet completed it but plans to do so at some point in the future." And, the cases cited by Mid-Continent actually all support that position, as none of them suggested that the exclusion applies to damage occurring during a prolonged suspension of construction work. Because JHP was not actively engaged in construction work at the time of the water intrusion, the exclusion did not apply. *JHP*, 557 F.3d at 213–14.

2. Exclusion J(6)

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

In support of its position, Mid-Continent relied on *Southwest Tank & Treater Manufacturing Co. v. Mid-Continent Casualty Co.*, 243 F. Supp. 2d 597 (E.D. Tex. 2003), in which the court found that J(6) barred coverage for damage to an entire tank that the insured was hired to install. The Fifth Circuit, however, noted that its recent decision in *Gore Design Completions, Ltd. v. Hartford Fire Insurance Co.*, 538 F.3d 365 (5th Cir. 2008), had acknowledged that the *Southwest Tank* court "focused on the insured's work on the entire tank that was damaged, rather than on a particular part." *Id.* at 371 n.8. Accordingly, the case had no bearing on the instant analysis where the defective work at issue was performed on a discrete portion of an overall project. *JHP*, 557 F.3d at 214.

Gore, in fact, lent support to TRC's position. In that case, an insured subcontractor incorrectly wired a component for an in-flight entertainment/cabin management system on a commercial plane. As a result, substantial damage occurred in the plane's electrical system. The Fifth Circuit rejected the insurer's argument that J(6) applied to the entire aircraft. In particular, the court found that "[the insurer's] reading of the exclusion reads out the words 'that particular part.'" *Gore*, 538 F.3d at 371. The court said that if the exclusion were meant to bar coverage for the entire property, then the exclusion should not include the language "that particular part." *JHP*, 557 F.3d at 214. As the Fifth Circuit noted:

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

Id.

Turning back to the case at bar, the Fifth Circuit held that "[t]he plain meaning of the exclusion . . . is that property damage only to parts of the property that were themselves the subjects of the defective work is excluded." Further, the court said, "[t]he narrowing 'that particular part' language is used to distinguish the damaged property that was itself the subject of the defective work from other damaged property that was either the subject of nondefective work by the insured or that was not worked on by the insured at all." *Id.* at 215.

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

> We find that exclusion j(6) bars coverage only for property damage to parts of a property that were themselves the subject of defective work by the insured; the exclusion does not bar coverage for damage to parts of a property that were the subject of only nondefective work by the insured and were damaged as a result of defective work by the insured on other parts of the property.

Id.

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

jected in Texas. *See Barnett v. Aetna Life Ins. Co.*, 723 S.W.2d 663, 666 (Tex. 1987) (finding that the mere fact that a policy is designated as a commercial general liability policy is not grounds for overlooking the actual language contained in the policy). As the Supreme Court of Texas said in *Lamar Homes*, such "preconceived notion[s] . . . must yield to the policy's actual language," and "coverage for [business risks] depends, as it always has, on the policy's language, and thus is subject to change when the terms of the policy change." *Lamar Homes*, 242 S.W.3d at 13–14.

As a result, because no allegations existed that JHP performed defective work on the interior portions of the condominiums, the damage to such property was not excluded from coverage under J(6). Rather, only the exterior finishes and retaining walls are "[t]hat particular part of any property that must be restored, repaired or replaced because [JHP's work] was incorrectly performed on it." *JHP*, 557 F.3d at 217.

C. Fully Adversarial Proceeding

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

Because the suit before the Fifth Circuit was not an action against defendant's insurer by plaintiff as defendant's assignee, *Gandy* was not implicated. Thus, *Block* controlled, and because Mid-Continent breached its duty to defend, it was bound by the default judgment awarded against its insured. *JHP*, 557 F.3d at 218.

Commentary:

The Fifth Circuit's opinion in *JHP* is the latest in a growing line of cases in Texas where courts adhere to the plain language in the insurance policy while rejecting arguments about what the insurer *meant* to exclude. As a result, insureds continue to gain traction with respect to the proper interpretation of CGL policies for construction defect lawsuits. This decision is particularly significant in that it addresses the two main "course of construction" exclusions, which previously had been interpreted to broadly exclude property damage that occurred during construction. It also is important because, in light of the resolution of the "property damage" and "occurrence" issues in *Lamar Homes* and the adoption of an "injury-in-fact" trigger in *Don's Building Supply*, the course of construction exclusions are more important in analyzing coverage for construction defect claims.

While the Fifth Circuit's decision regarding J(5) is not earth-shattering, its analysis regarding the "that particular part" phrase in J(6) is extremely important. Insurers typically argue that the "that particular part" language—which is found in both J(5) and J(6)—should equate with the scope of the insured's contractual undertaking. Accordingly, for general contractors, the view was that any property damage to the project itself (i.e., the condominiums) that occurred during construction was excluded from coverage. And, since neither exclusion J(5) nor J(6) has a subcontractor exception like exclusion L, this broad interpretation oftentimes was fatal to coverage. The Fifth Circuit, however, correctly applied contract interpretation principles and limited the "that particular part" language such that it does not apply to otherwise non-defective work that is damaged during the course of construction—even if it is damaged as a result of the insured's defective work.[4]

In addition, the court's adherence to the *Block* and *ATOFINA* line of cases also is significant. By binding Mid-Continent to the default judgment, more insurers might now think twice before denying an insured a defense outright. The better course, in cases of doubt, is for the insurer to assume the duty to defend and file a declaratory judgment action.

III. *Pine Oak Builders, Inc. v. Great American Lloyds Insurance Co.*, 279 S.W.3d 650 (Tex. 2009)

On February 13, 2009, the Supreme Court of Texas issued another important opinion for insurance law jurisprudence. *See Pine Oak Builders, Inc. v. Great Am. Lloyds Ins. Co.*, 279 S.W.3d 650 (Tex. 2009). And, in doing so, the Court reaffirmed three of its recent insurance law decisions. First, the Court applied its prior decision in *Lamar Homes, Inc. v. Mid-Continent Casualty Co.*, 242 S.W.3d 1 (Tex. 2007), finding that faulty-workmanship claims can allege "property damage" caused by an "occurrence" and that the Prompt Payment of Claims Act applies to an insurer's breach of its duty to defend its insured under a liability policy. Second, the Court also applied its recent decision in *Don's Building Supply, Inc. v. OneBeacon Insurance Co.*, 267 S.W.3d 20 (Tex. 2008), remanding the case to the trial court so that it can apply the injury-in-fact rule (as opposed to the exposure rule applied by the court of appeals) to determine whether the property damage claims fall within the insurers' policies. Third, and most importantly, the court addressed the ongoing debate regarding the use of extrinsic evidence to determine an insurer's duty to defend its insured. Again, the Court acknowledged its holding in *GuideOne Elite Insurance Co. v. Fielder Road Baptist Church*, 197 S.W.3d 305 (Tex. 2006), in which it rejected an exception for "overlapping" facts. It applied that same finding to the issues before it and found that extrinsic evidence could not be admitted and that Pine Oak Builders was not entitled to a defense from its insurer for the claims asserted against it by one of five separate plaintiffs.

[4] One court already has applied *JHP* to narrowly interpret the "that particular part" language in a case involving damage to a portion of an oil well. *See Basic Energy Services, Inc. v. Liberty Mut. Ins. Co.*, 2009 WL 2998134 (W.D. Tex. Sep. 18, 2009).

A. The Background Facts

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

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

Great American and Mid-Continent refused to defend Pine Oak, so Pine Oak filed a declaratory judgment action against both of them. The insurers counterclaimed and all parties moved for summary judgment. Pine Oak urged a finding that it was entitled to a defense and damages. Great American argued that its policies did not cover the claims in the underlying lawsuits and Mid-Continent argued that its EIFS exclusion barred coverage. The trial court ruled in favor of the insurers on all the motions. The court of appeals affirmed as to Mid-Continent because of the application of its EIFS exclusion. The court of appeals reversed as to Great American on four of the underlying lawsuits because it concluded that the allegations constituted "property damage" caused by an "occurrence" and further held that the Great American policies—which did not have an EIFS exclusion—were triggered under an exposure trigger. As to the *Glass* lawsuit, however, the appellate court affirmed as to both Mid-Continent and Great American due to application of exclusion L—the "your work" exclusion—given the absence of any allegation that a subcontractor performed the work. The case as to Great American's duty to defend was then appealed to the Supreme Court.

B. *Lamar Homes* Applies

At the outset, the Supreme Court of Texas said that *Lamar Homes* foreclosed the insurers' argument that the faulty-workmanship claims asserted against Pine Oak did not constitute "property damage" caused by an "occurrence." *Pine Oak*, 279 S.W.3d at 652. The Court said that the relevant language in the Great American policies was identical to that addressed in *Lamar Homes*. *Id.* In addition, the Court agreed with Pine Oaks that *Lamar Homes* also applied regarding the Prompt Payment of Claims Act. In particular, the Court found that the statute applies to Great American's breach of the duty to defend. *Id.* (citing *Lamar Homes*, 242 S.W.3d at 5, 20).

C. *Don's Building Supply* Applies

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

Of course, as discussed earlier in this paper, the Court already had rejected both such trigger rules in its decision in *Don's Building Supply*, adopting instead an "actual injury rule."

Under that rule, "property damage occurs during the policy period if 'actual physical damage to the property occurred' during the policy period." *Pine Oak*, 279 S.W.3d at 653 (quoting *Don's Building Supply*, 267 S.W.3d at 24). The Court noted that the policy language before it in *Pine Oak* was identical to the language addressed in *Don's Building Supply*, and thus, the same rule applied. As such, the Court ordered the trial court to apply the "actual injury rule" on remand "to any remaining disputes about whether the property-damage claims fall within the terms of the Great American policies."[5] *Id.*

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

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

In four of the underlying lawsuits, the homeowners specifically alleged that the defective work was performed by subcontractors, but the *Glass* lawsuit omitted any reference to defective work performed by a subcontractor. Rather, Pine Oak was alleged to have failed to perform its work in a good and workmanlike manner and failed to make requested repairs. *Id.* at 653–54. In Pine Oak's lawsuit against the insurers, the company submitted extrinsic evidence that the work at issue was performed by Pine Oak's subcontractors, and thus it contended that Great American had to defend the company in the *Glass* lawsuit. *Id.* at 654.

The Court acknowledged that the duty to defend is determined by the "eight corners" of the insurance policy and the underlying pleading. It noted that its decision in *GuideOne Elite Insurance Co. v. Fielder Road Baptist Church*, 197 S.W.3d 305 (Tex. 2006), had been issued six days before the appellate court's ruling in the Pine Oak matter. In *GuideOne*, "[w]ithout recognizing an exception to the eight-corners rule, we held that any such exception would not extend to evidence that was relevant to both insurance coverage and the factual merits of the case alleged by the third-party plaintiff." *Pine Oak*, 279 S.W.3d at 654 (quoting *GuideOne*, 197 S.W.3d at 309).

Applying that rule to the case before it, the Court found that Pine Oak's evidence contradicts the facts alleged in the *Glass* lawsuit. In particular, the plaintiffs in that case alleged that Pine Oak constructed the columns and balcony at issue and that Pine Oak failed to perform its work in a good and workmanlike manner and failed to make repairs. *Id.* Such claims were barred from coverage by exclusion L of the CGL policy. Notably, "[f]aulty workmanship by a subcontractor that might fall under the subcontractor exception to the 'your work' exclusion is not mentioned in the petition." *Id.* at 655. "If the petition only alleges facts excluded by the policy, the insurer is not required to defend." *Id.* (quoting *Fid. & Guar. Ins. Underwriters, Inc. v. McManus*, 633 S.W.2d 787, 788 (Tex. 1982)).

[5] As noted in *Don's Building Supply*, however, the application of an injury-in-fact trigger as opposed to an exposure trigger oftentimes will not produce a different result. *See Don's Building Supply*, 267 S.W.2d at 29 n.34.

Nevertheless, Pine Oak urged that the petition could be read to find that the culpable party in the *Glass* lawsuit was either Pine Oak or a subcontractor. Again, the Court disagreed. The petition in the *Glass* lawsuit, in contrast to the other four cases, did not allege faulty work by a subcontractor, did not allege that Pine Oak was liable for any subcontractor's work and did not allege negligent supervision of a subcontractor. *Id.* Rather, the petition alleged that Pine Oak—and only Pine Oak—was liable for its own actionable conduct. *Id.* The Court said that in "deciding the duty to defend, the court should not consider extrinsic evidence from either the insurer or the insured that contradicts the allegations of the underlying petition." *Id.* Because Pine Oak's evidence would have changed the allegations of the underlying lawsuit, it was inadmissible. "The policy imposes no duty to defend a claim that might have been alleged but was not, or a claim that more closely tracks the true factual circumstances surrounding the third-party claimant's injuries but which, for whatever reason, has not been asserted." *Id.* at 655–56. Consequently, because the duty to defend does not extend to allegations—true or false—that have not been made, Great American's duty to defend was not triggered by the *Glass* lawsuit. *Id.* at 656.

In finding that Great American did not owe a defense in that underlying lawsuit, the Court affirmed the appellate court's opinion. The appellate court had ruled that because no duty to defend existed, Great American also was not obligated to indemnify Pine Oak. Thus, without explicitly stating so, the Court affirmed the holding that "no duty to defend means no duty to indemnify."

E. Different Case, Same Result

On the same day *Pine Oak* was decided, the Supreme Court of Texas also denied the petition in *D.R. Horton—Texas, Ltd. v. Markel International Insurance Company, Ltd.*, No. 06-1018 (Tex. Feb. 13, 2009). In that case, similar facts existed in that D.R. Horton was alleged to have performed faulty work related to masonry on a home that it built. *See D.R. Horton—Texas, Ltd. v. Markel Int'l Ins. Co., Ltd.*, 2006 WL 3040756 (Tex. App.—Houston [14th Dist.] Oct. 26, 2006), pet. granted).[6] The masonry work was completed by a subcontractor, but the subcontractor was not mentioned at all in the pleadings in the underlying lawsuit. The appellate court adhered to the "eight corners" rule and refused to admit D.R. Horton's extrinsic evidence that would have entitled it to a defense as an additional insured under its subcontractor's policy. *Id.* at *5. Thus, the court of appeals ruled that no duty to defend existed. In addition, like the appellate court in *Pine Oak*, the court of appeals in *D.R. Horton* held that a finding of no duty to defend necessarily means that no duty to indemnify ever can exist. *Id.* at *6.

On March 2, 2009, D.R. Horton filed a motion for rehearing with the Supreme Court of Texas. And, on March 12, 2009, the National Association of Home Builders and the Texas Association of Builders filed an amicus curiae brief in support of the rehearing. After receiving additional briefing, including a response and reply to the motion for rehearing, the Court withdrew its February 13, 2009 denial of the petition for review and issued an order granting the petition for review. Oral argument was heard on September 8, 2009.

[6] While initially the Court denied the petition for review in *D.R. Horton*, the Court ultimately withdrew that denial and *granted* the petition following a motion for rehearing.

Commentary:

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

Presumably, the Court may still recognize a limited exception for "coverage only" facts. Take the following scenario: A homebuilder like Pine Oak could be sued by a homeowner, who alleges that faulty work was performed by the homebuilder *and* its subcontractor, but the homeowner does not specifically name the subcontractor at issue. In that case, introduction of extrinsic evidence in order to supply the name of the subcontractor at issue should constitute "coverage only" evidence that does not contradict the allegations asserted or overlap with the liability facts. Instead, the evidence would merely replace the general term "subcontractor" with the specific names of such subcontractor.[7] A similar situation has occurred in the past and been found acceptable. *See Int'l Serv. Ins. Co. v. Boll*, 392 S.W.2d 158 (Tex. Civ. App.—1965, writ ref'd n.r.e.) (finding that the petitions filed against a father for an accident occurring while his son was driving the car did not trigger a duty to defend because the father's only son was Roy Hamilton Boll, who specifically was excluded from coverage, even though Roy was not mentioned in the pleadings at issue). Provided that the homebuilder seeks to introduce the evidence in order to trigger coverage—as opposed to defeat its liability to the homeowner—the evidence arguably could be allowed as "coverage only" evidence.

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

IV. *State Farm Lloyds v. Johnson*, 2009 WL 1900538 (Tex. July 3, 2009)

On July 3, 2009, the Supreme Court of Texas issued its long-awaited decision in *State Farm Lloyds v. Johnson*, 2009 WL 1900538 (Tex. July 3, 2009), holding in a unanimous opinion that State Farm Lloyds could not avoid its insured's demand for appraisal to determine the insured's amount of loss under a homeowners insurance policy. In doing so, the Court shed important light on the scope of a standard appraisal clause found in almost every first-party insurance policy.

[7] While introduction of the subcontractor's name would not be important for applying the subcontractor exception to exclusion L, it would be important if the general contractor was trying to trigger additional insured status under a particular subcontractor's policy. *See, e.g., D.R. Horton–Texas, Ltd. v. Markel Int'l Ins. Co., Ltd.*, 2006 WL 3040756 (Tex. App.—Houston [14th Dist.] Oct. 26, 2006), pet. granted).

A. Background Facts

In April 2003, a hailstorm passed through Plano, Texas, damaging Becky Ann Johnson's roof. Johnson filed a claim under her homeowners insurance policy, which was issued by State Farm Lloyds. The insurer's inspector found that only her ridgeline was damaged and that repairs would be less than $500—and thus less than her policy deductible. Johnson's inspector, on the other hand, found that the entire roof needed replacement to the tune of more than $13,000—and significantly more than the policy deductible.

Unable to reach a resolution, Johnson demanded appraisal of the "amount of loss" under the standard form appraisal clause, which provided:

> **Appraisal.** If you and we fail to agree on the ***amount of loss***, either one can demand that the amount of the loss be set by appraisal. If either makes a written demand for appraisal, each shall select a competent, disinterested appraiser. Each shall notify the other of the appraiser's identity within 20 days of receipt of the written demand. The two appraisers shall then select a competent, impartial umpire . . . . The appraisers shall then set the amount of the loss. If the appraisers submit a written report of an agreement to us, the amount agreed upon shall be the amount of the loss. If the appraisers fail to agree within a reasonable time, they shall submit their differences to the umpire. Written agreement signed by any two of these three shall set the amount of the loss.

Id. at *1 (emphasis added). State Farm would not participate, however, claiming that the dispute was not about the "amount of loss," but about causation. As a result, Johnson filed a declaratory judgment action, seeking an order compelling appraisal under the policy. At the state district court, State Farm prevailed on cross-motions for summary judgment, but the court of appeals reversed. The Supreme Court "granted State Farm's petition to decide whether the dispute here fell within the scope of this appraisal clause." *Id.* (noting that briefs supporting State Farm's position were filed by the Texas Windstorm Insurance Association and the Property Casualty Insurers Association of America).

B. Appraisal Clauses – A Brief History

The Court noted that appraisal clauses are commonplace and have a long history in Texas, dating to at least 1888 when the Court enforced a similar appraisal clause in *Scottish Union & National Insurance Co. v. Clancy*, 8 S.W. 630, 631 (Tex. 1888). While the Court did not necessarily approve of such clauses then, it certainly found them enforceable. *State Farm Lloyds*, 2009 WL 1900538, at *1–*2. And, as the Court noted, similar clauses appear in almost every first-party insurance policy in Texas, including homeowners, automobile, and property policies. *Id.* at *2 (citations omitted).

Despite the long history of such provisions, the Court only has issued six decisions on them, including the *Scottish Union* decision. And, in those cases, the issue was whether the clause was enforceable or had been waived. The Supreme Court had never resolved a dispute regarding the scope of such provisions or determined the meaning of "amount of loss."

C. Questions of Damages and Questions of Liability

Returning to its decision in *Scottish Union* the Court quoted its opinion, noting the distinction between appraisal and arbitration:

> But here the [appraisal clause] does not divest the courts of jurisdiction, but only binds the parties to have the extent or amount of the loss determined in a particular way, leaving the question of liability for such loss to be determined, if necessary, by the courts.

Id. (quoting *Scottish Union*, 8 S.W. at 631). And, nine years later, a similar distinction was made "between *damage* questions for appraisers and *liability* questions for the courts." *Id.* (citing *Am. Cent. Ins. Co. v. Bass*, 38 S.W. 1119 (Tex. 1897)).

The court further noted that the definition of "appraisal" generally means "[t]he determination of what constitutes a fair price; valuation; estimation of worth." *Id.* (quoting BLACK'S LAW DICTIONARY 110 (8th ed. 2004)). And, as such, appraisers are instructed by the policy to determine the *amount of loss* and not opine as to the construction of the policy or the obligation of the insurer to pay such amount.

In light of the foregoing, and in light of the fact that few cases exist on the subject of appraisal clauses, the Court found that its 1888 test in *Scottish Union* still applied: the scope of appraisal is damages, not liability. *Id.* at *3.

D. What is the Scope of Appraisal Here?

With that backdrop, the Court turned to the instant case in which State Farm argued that appraisal was inappropriate for Johnson's claim, as causation could not be decided by the appraisers. Acknowledging that courts in Texas and across the country were split on that issue, the Court found that—as a matter of law—it could not be established that the dispute was *only* about causation or that the dispute was beyond the scope of the appraisal clause.

In its motion for summary judgment, State Farm claimed that only Johnson's shingles on her roof ridgeline were damaged by the hail, but the Court found that the determination of the number of shingles damaged and in need of replacement surely was a question for appraisers. In support, the Court commented that if an agreement must be reached between the parties before appraisal as to the precise number of shingles that need to be replaced, appraisal would not be necessary at all. And, one party could avoid appraisal outright by simply adding a few more shingles to the bundle. Simply put, because an appraiser must know the number of shingles and the shingle price in order to determine the "amount of loss," a disagreement between the parties as to the number of shingles needing replacement surely fell within the scope of the appraisal clause. *Id.*

State Farm was focused not only on which shingles were damaged, but—more specifically—which shingles were damaged by *hail*. Missing from State Farm's case, however, was anything at all that established that the shingles were damaged by anything *but* hail. The Court said: "The trial court could not conclude this was a causation dispute just because State Farm claimed it was."

The Court also found that the record did not establish that the dispute solely was about how much of the roof had been damaged versus how much of the roof needed to be replaced. "Sometimes it may be unreasonable or even impossible to repair one part of a roof without replacing the whole." *Id.* (citation omitted). The policy states that the insurer will pay to "repair or replace" damaged property and that is an "amount of loss" question for the appraisers to decide. Accordingly, the Court held that the trial court could not conclude as a matter of law that Johnson's and State Farm's dispute was about causation instead of something different.

Moreover, the Court said, even if the dispute involved causation, that would not prove that the dispute was a question of liability as opposed to a question of damages. Rather, causation is the connection between liability and damages. Of course, in actual cases, causation does tend to fall into one category or the other.

For instance, when more than one cause is alleged to have resulted in a single injury to property, causation is a liability question. *Id.* at *4 (citing *Wells v. Am. States Preferred Ins. Co.*, 919 S.W.2d 679, 685–86 (Tex. App.—Dallas 1996, writ denied)). In such cases, the appraisers can decide the cost to repair but they cannot decide causation because that would be a question for the trial court.

On the other hand, in some cases, different types of damage exist with regard to different types of property. In such cases, the appraisers have to decide the damage caused by each before the court can answer the liability question. *Id.* (citing *Lundstom v. United Servs. Automobile Ass'n*, 192 S.W.3d 78, 88 (Tex. App.—Houston [14th Dist.] 2006, pet. denied)). Accordingly, if the courts decide whether one type of damage or another is covered and also decides the amount of damage caused by each, then the courts leave the appraisers with nothing to do.

The Court recognized that the same issue arises when the question of causation requires separating a covered loss from a pre-existing condition. State Farm's position, for example, supports a finding that if appraisers cannot allocate damages between covered and excluded perils, then appraisers only can assess hail damage if a roof is brand new because all other roofs would have experienced wear and tear—an excluded cause of loss. Because that would render appraisal clauses inoperative, the Court acknowledged that it must avoid construing the policy in that way. That finding was supported by its refusal of writ in *Gulf Insurance Co. of Dallas v. Pappas*, 73 S.W.2d 145, 146 (Tex. Civ. App.—San Antonio 1934, writ ref'd)), in which the appellate court ruled that appraisers should decide how much floors of a building sagged before a fire and whether the building's interior should be repaired or replaced in order to return the insured building to its previous condition. It was not a question for a jury. And, by refusing the writ, the Court adopted that decision as its own and essentially held that appraisers can take pre-existing conditions into consideration in determining the amount of an insured's loss.

The Court said:

> Indeed, appraisers must always consider causation, at least as an initial matter. An appraisal is for damages caused by a specific occurrence, not every repair a home might need. When asked to assess hail damage, appraisers look only at damage caused by hail; they do not consider leaky faucets or remodeling the kitchen. When asked to assess damage from a fender-bender, they include dents caused by

> the collision but not by something else. Any appraisal necessarily includes some causation element, because setting the "amount of loss" requires appraisers to decide between damages for which coverage is claimed from damages caused by everything else.

State Farm Lloyds, 2009 WL 1900538, at *4. But, of course, an insurer does not have to pay for repairs necessitated by excluded perils. And, whether particular appraisers exceed their damage questions will depend on the nature of the damage, the causes of that damage, the parties' dispute of the damage, and the structure of the appraisal award reached by the appraisers. Because those issues *might* include a causation question beyond the scope of appraisal does not allow State Farm to avoid its appraisal clause. *Id.* at *5.

Before concluding that appraisal should be compelled, the Court noted that the case before it was in an unusual posture. In particular, normally cases involve a dispute of an appraisal that already has occurred, but in the instant case no appraisal had taken place. The Court expressed its disapproval of that posture. In particular, the Court said that appraisal was meant to occur pre-suit and to allow litigation of the scope of appraisal before suit would only encourage more of the same. And, in any event, appraisal awards can be structured so as not to step on the toes of the courts: When a single injury might have several causes, the appraisers can determine the amount of damage and let the courts decide what caused it. Or, when the damages are divisible, the appraisers can determine the repair cost for each and let the courts decide who should pay for it. Additionally, the Court found that the lack of case law on the scope of appraisal supports a belief that appraisal itself probably resolves such issues on its own. Finally, if an appraisal award ultimately is flawed, it can always be challenged later and a dishonest assessment of the damages can be set aside by the courts. *Id.*

Put simply, in any property damage claim someone must decide the amount of the loss suffered because it is that amount that the insurer has to pay. Appraisal clauses bind the parties to such an amount through a particular process. And, like any contractual provision, the Court found that appraisal clauses should be enforced. And, although a rare case may exist in which appraisal is unnecessary because the cost is prohibitive and coverage is unlikely, "unless the 'amount of loss' will never be needed . . . appraisals should generally go forward without preemptive intervention by the courts." *Id.* at *6. Accordingly, the Court affirmed the appellate court and compelled State Farm to participate in the appraisal process.

E. The Aftermath

On July 23, 2009, the U.S. District Court for the Southern District of Texas addressed the appraisal clause in the context of Hurricane Ike. *See Molzan, Inc. v. United Fire & Cas. Co.*, 2009 WL 2215092 (S.D. Tex. July 23, 2009). The court noted that the Supreme Court had decided *Johnson*, a case relied on by Molzan, after the parties submitted their briefs. Upon analyzing the *Johnson* decision, the federal court found it to be directly on point. In particular, like in *Johnson*, the parties did not dispute that a covered cause of loss occurred (i.e., the hurricane), but disagreed as to whether the event caused the damage to the items claimed. *Id.* at *4. Additionally, as in *Johnson*, the case was before the court in an "unusual posture" because no appraisal had yet occurred. *Id.* (citing *Johnson*, 2009 WL 1900538 at *5). Accordingly, the court granted

the insured's motion to compel appraisal, finding appraisal appropriate for both the business income claim and the property damage claims filed by Molzan. *Id.*

At least one court, however, has questioned a portion of the Supreme Court's opinion in *Johnson*. *See Sunquest Props., Inc. v. Nationwide Prop. & Cas. Co.*, 2009 WL 2567280 (S.D. Miss. Aug. 19, 2009). In that case, the Mississippi federal court found the Supreme Court's comments "questionable" that "[a]ppraisals require no attorneys, no lawsuits, no pleadings, no subpoenas, and no hearings" and that "[i]t would be a rare case in which appraisal could not be completed with less time and expense that in would take to file motions contesting it." *Id.* at *1 (quoting *Johnson*, 2009 WL 1900538 at *5). In fact, the parties before the Mississippi court felt that requiring the parties to "re-request appraisal and reconvene in hopes of reaching some common ground is futile. This will only waste time; the parties will inevitably be before this Court again, disputing some issue of appraisal." *Id.* Nevertheless, the Court ordered the parties to appraisal and noted that any challenge to its validity would occur only after it took place. *Id.* at *2.

On August 17, 2009, the McAllen Division of the Southern District of Texas issued an opinion in *Financial Management International, Inc. d/b/a The Summit Sports Club v. Mt. Hawley Insurance Co.*, Civil Action No. M-08-267 (S.D. Tex. Aug. 17, 2009), addressing the *Johnson* decision. In that case, the insurer was the party seeking appraisal, arguing that the *Johnson* opinion was favorable to its position, as appraisal was appropriate for determining causation. Slip op. at 2. While the court agreed that appraisal might be appropriate, it found that the Summit Sports Club met its burden of establishing that Mt. Hawley had waived its right to appraisal under the policy. *Id.* at 3. Because Mt. Hawley participated in the litigation process for over a year and because Mt. Hawley knew it had an argument in support of appraisal but did not pursue it earlier, the court refused to compel appraisal. *Id.* at 4–5

Commentary:

The Supreme Court's decision in *Johnson* clarifies the use and benefits of appraisal in a first-party insurance policy. The Court once again recognized that contracts should be interpreted as written. Accordingly, if a policy has an appraisal clause, the Court is inclined to enforce it.

Perhaps surprisingly for policyholders and insurers alike is that the Court found that an appraiser's duty under the clause is not as confined as most thought. That is, while most believed that an appraisal clause only could be invoked once all other issues had been resolved, including liability and causation, the Court made clear that that is not always the case.

Simply put, the appraisal clause can be a useful tool for getting hard numbers in front of the parties in order to facilitate resolution before litigation. In other words, the appraisers—without telling the insurer what it has to pay—can take into account damages that may have been caused by either excluded or covered perils. By drafting an award that categorizes the damages between different causes and attributing a repair or replacement dollar amount to those damages, the appraisers can leave the question of liability to the parties—or the courts—to resolve. And, as the Court noted, doing so from the outset might answer the liability questions for the parties without the need for a lawsuit. Undoubtedly, the opinion in *Johnson* will increase the use of appraisal as a mechanism for resolving first-party disputes.

CASES IN THE PIPELINE

I. *D.R. Horton-Texas, Ltd. v. Markel International Insurance Co.*

A. A Little History

On June 30, 2006, the Supreme Court of Texas handed down its long-awaited opinion on whether extrinsic evidence is admissible in the duty to defend analysis. *See GuideOne Elite Ins. Co. v. Fielder Road Baptist Church*, 197 S.W.3d 305 (Tex. 2006). In so doing, the Court declined to adopt an exception to the "eight corners" rule. Nevertheless, the Supreme Court was careful to limit its decision to situations when the extrinsic evidence is "relevant both to coverage and the merits . . . ." *GuideOne*, 197 S.W.3d at 310. More specifically, the court refused to adopt any exception to the "eight corners" rule for "liability only" or "overlapping/mixed fact" scenarios:

> [W]ere we to recognize the exception urged here, we would by necessity conflate the insurer's defense and indemnity duties without regard for the policy's express terms. Although these duties are created by contract, they are rarely coextensive.

Id. at 310 (citations omitted). Moreover, in reaching its decision, the court did not disapprove of other case law and commentary that discussed a "coverage only" exception to the "eight corners" rule. As recognized by the Supreme Court of Texas, authority exists for admitting extrinsic evidence in "coverage only" situations—at least when the "coverage only" evidence involves fundamental coverage facts that can be readily ascertained and are undisputed. Although allowing extrinsic evidence in such circumstances may technically violate a strict "eight corners" rule, the reality is that considering "coverage only" evidence does not violate the contractual underpinnings of the duty to defend. Moreover, insurers still will have to defend groundless, false, or fraudulent claims that otherwise state a potential for coverage. Under a "coverage only" exception, for example, insurers only will be able to avoid the duty to defend in situations when the insured has not paid premiums for a defense (e.g., when the defendant is not listed as an insured, or where the property is not scheduled on the policy). Unfortunately, in *GuideOne*, the Supreme Court of Texas did not expressly say one way or the other whether it would recognize a "coverage only" exception.

Subsequent to the issuance of *GuideOne*, one court noted the following:

> Although the Texas Supreme Court explicitly rejected the use of extrinsic evidence that was relevant both to coverage and to the merits of the underlying action, it did not rule on the validity of a more narrow exception that would allow extrinsic evidence solely on the issue of coverage. In fact, the language of the opinion hints that the court views the more narrow exception favorably. For example, the court specifically acknowledged that other courts recognized a narrow exception for extrinsic evidence that is relevant to the discrete issue of coverage and noted that the Fifth Circuit had opined that, were any exception to be recognized by the Texas high court, it would likely be such a narrow exception.

Bayou Bend Homes v. Scottsdale Ins. Co., 2006 WL 2037564 (S.D. Tex. July 18, 2006). And, subsequent to *Bayou Bend Homes*, one court has expressly concluded that a "coverage only" ex-

ception applies under Texas law. *See B. Hall Contracting Inc. v. Evanston Ins. Co.*, 447 F. Supp. 2d 634, 647 (N.D. Tex. 2006) (holding that "coverage only" extrinsic evidence can be considered in the duty to defend analysis), *rev'd on other grounds*, 273 F. App'x 310 (5th Cir. Apr. 8, 2008). Likewise, the Fifth Circuit has interpreted *GuideOne* as permitting extrinsic evidence in "coverage only" scenarios. *See Liberty Mut. Ins. Co. v. Graham*, 473 F.3d 596 (5th Cir. Dec. 21, 2006).

Even if admission of "coverage only" facts is allowed, an insurer should not be permitted to use such evidence to contradict allegations in a petition. Likewise, when a potential for coverage can be found from the face of a pleading, an insurer should not be permitted to develop extrinsic evidence through discovery in an effort to defeat the duty to defend. *See Fair Operating, Inc. v. Mid-Continent Cas. Co.*, 193 F. App'x. 302 (5th Cir. Aug. 1, 2006) (affirming district court's order refusing insurer's request to undertake discovery of extrinsic evidence).

B. The Appellate Court Decision in *D.R. Horton*

In *D.R. Horton*, the Houston Court of Appeals addressed the duty to defend and extrinsic evidence issue in the context of an additional insured tender. In 2002, James and Cicely Holmes sued D.R. Horton alleging that their house contained latent defects that led to the propagation of toxic mold. The Holmes' petition was silent about D.R. Horton's use of subcontractors to construct the home. In particular, the Holmes' petition did not name any subcontractors, nor did it make any reference to damage caused by any of D.R. Horton's subcontractors. D.R. Horton, however, had extrinsic evidence that demonstrated that the alleged damages to the home were caused, at least in part, by work performed on D.R. Horton's behalf by its masonry subcontractor.

Accordingly, since D.R. Horton required its subcontractors to name it as an additional insured, D.R. Horton tendered the Holmes' lawsuit to the liability carriers for the masonry subcontractor. Those insurers, however, declined to defend D.R. Horton based on the fact that the Holmes' petition failed to mention the use of or otherwise reference any subcontractors. In particular, the additional insured endorsement limits the insurer's liability to those claims arising out of the named insured's (i.e., the masonry subcontractor) work for the additional insured (D.R. Horton).

In the coverage litigation against the additional insured carriers, D.R. Horton sought to introduce extrinsic evidence that the damages to the home were caused by the masonry subcontractor (i.e., the named insured). The trial court refused to permit the use of extrinsic evidence. The court of appeals, while recognizing that D.R. Horton "produced a significant amount of summary judgment evidence that . . . links [the masonry subcontractor] to the injuries claimed by the Holmeses," concluded that the trial court properly excluded the evidence. *D.R. Horton*, 2006 WL 3040756, at *5. In particular, without explaining its basis, the court of appeals side-stepped the debate by classifying the extrinsic evidence before it as relating to both coverage and liability. *See D.R. Horton*, 2006 WL 3040756, at *5 n.11.

After ruling that no duty to defend existed, based on a strict "eight corners" analysis, the court of appeals then ruled that there necessarily can be no duty to indemnify. In most cases, the negation of the duty to defend also will negate the duty to indemnify. *See Farmers Tex. County Mut. Ins. Co. v. Griffin*, 955 S.W.2d 81, 84 (Tex. 1997). This fact, however, oftentimes is over-

stated as an absolute rule. *See, e.g.*, *Am. States Ins. Co. v. Bailey*, 133 F.3d 363 (5th Cir. 1998) ("Logic and common sense dictate that if there is no duty to defend then there must be no duty to indemnify."); *see also Century Sur. Co. v. Hardscape Constr. Specialties*, 2006 WL 1948063 (N.D. Tex. July 13, 2006) ("Of course, when there is no duty to defend, there is also no duty to indemnify."), *aff'd on other grounds*, 2009 WL 2413935 (5th Cir. Aug. 7, 2009).[8] Notably, a quick Westlaw or Lexis search will reveal dozens of cases that stand for the proposition that if there is no duty to defend, there can be no duty to indemnify. While oftentimes true, such a conclusion is by no means automatic. Even if an insurer obtains a judgment as to defense and indemnity based on a particular petition or complaint, for example, it always is possible that the petition or complaint can be amended to trigger a duty to defend. For example, in *Nautilus Insurance Co. v. Nevco Waterproofing, Inc.*, 2005 WL 1847094 (S.D. Tex. Aug. 3, 2005), *vacated and remanded*, 202 F. App'x. 667 (5th Cir. 2006), the court noted as follows:

> This Court's ruling [on the duty to indemnify] is issued without prejudice and is based on the petition in the underlying suit at the time the court ruled. The Court does not intend to preclude Nevco from seeking indemnity from Evanston if Nevco is found liable on a theory that was not pleaded in Concierge's operative petition when construed broadly.

Id. at *3 n.6. Similarly, in *Markel International Insurance Co. v. Campise Homes, Inc.*, 2006 WL 1662604 (S.D. Tex. June 6, 2006), the court concluded that:

> The resolution of the duty to defend issue is not automatically dispositive of the issue of indemnity. An insurer's duty to indemnify is distinct and separate from its duty to defend . . . . However, "[l]anguage in some cases can be read to indicate that if the live pleading at the time a determination of the duty to indemnify is sought did not trigger the duty to defend, no duty to indemnify can be found." For example, if the same basis that negates the duty to defend likewise negates any possible duty to indemnify, then a court may properly consider the issue of indemnity. In the instant case, the Court cannot find that the same basis that negated the duty to defend negates any possible duty to indemnify. Due to the sloppy pleading in the underlying lawsuit, it remains a fundamental mystery when the alleged property damage occurred. The Wolfes' did not allege property damage within the policy period, therefore, there is no duty to defend. However, this does not conclusively resolve the issue of indemnification. Presumably, the conclusion of the underlying lawsuit will clarify when the alleged damaged occurred—outside or within the policy period. If the alleged damage occurred within the policy period, then there may be a duty to indemnify. It is impossible at this juncture to make a determination as to indemnification.

[8] The district court decision hinged on a finding that no "occurrence" existed, but, as noted by the Fifth Circuit, that finding was in contravention of the Supreme Court of Texas' decision in *Lamar Homes*, which was issued while the case was pending on appeal. *See Century Surety*, 2009 WL 2413935 at *2. Accordingly, the appellate court found an "occurrence" existed, but affirmed the decision of the district court against the insured based on the application of the "contractually assumed liability" exclusion. *See id.* at *6. The Fifth Circuit found that the same reasons that negated the duty to defend also negated the duty to indemnify. *Id.* (citing *Farmers Tex. County Mut. Ins. Co. v. Griffin*, 955 S.W.2d 81, 83–84 (Tex. 1997)).

Id. at *3 (internal citations omitted). *See also Admiral Ins. Co. v. Little Big Inch Pipeline Co., Inc.*, 523 F. Supp. 2d 524, 545–46 (noting that neither party presented evidence that any facts had been conclusively established in the underlying lawsuit and, thus, the possibility remained that later-alleged facts in an amended pleading could result in covered claims, rendering a ruling on the duty to indemnify based on the then-current facts premature). Likewise, if a plaintiff brings a lawsuit against the insured alleging only intentional conduct but is granted a trial amendment alleging non-intentional conduct and obtains a judgment on the alternative ground, the duty to indemnify should be triggered even though the insurer never defended. *See Trinity Universal Ins. Co. v. Cowan*, 945 S.W.2d 819, 825 n.4 (Tex. 1997) ("This holding does not affect a party's right to introduce evidence of physical manifestations of mental anguish against a tortfeasor under the 'fair notice' rule . . . . Our holding extends only to the duty to defend under the complaint allegation rule."); *see also* Ellen S. Pryor, *Mapping the Changing Boundaries of the Duty to Defend in Texas*, 31 TEX. TECH. L. REV. 869, 890–98 (2000). Accordingly, the rule is better stated as follows: When no duty to defend exists, and no facts can be developed at the trial of the underlying lawsuit to impose coverage, an insurer's duty to indemnify may be determined by summary judgment.

D.R. Horton filed a petition for review with the Supreme Court of Texas. In the petition for review, D.R. Horton refuted the contention that the extrinsic evidence related to both liability and coverage. Rather, D.R. Horton contended that the extrinsic evidence it sought to introduce went solely to coverage (i.e., additional insured status). D.R. Horton then urged the Supreme Court to take *GuideOne* one step further by expressly adopting a "coverage only" exception to the "eight corners" rule. Initially, the Supreme Court denied the petition. On March 2, 2009, D.R. Horton filed a motion for rehearing with the Supreme Court of Texas. And, on March 12, 2009, the National Association of Home Builders and the Texas Association of Builders filed an amicus curiae brief in support of the rehearing. After receiving additional briefing, including a response and reply to the motion for rehearing, the Court reversed course, withdrawing its February 13, 2009 denial of the petition for review and issuing an order granting the review. The Court heard oral argument on September 8, 2009.

C. Continued Confusion

While *D.R. Horton* remains pending, confusion as to the application of extrinsic evidence at the duty to defend stage is rampant. In the space of a few months, two panels from the Fifth Circuit Court of Appeals reached opposite conclusions on the issue. *Compare Mary Kay Holding Corp. v. Fed. Ins. Co.*, 309 F. App'x 843 (5th Cir. Feb. 6, 2009) (finding that no exception exists), *with*, *Ooida Risk Retention Group, Inc. v. Williams*, 2009 WL 2461850 (5th Cir. Aug. 12, 2009) (utilizing extrinsic evidence in evaluating an insurer's defense duty). In *Mary Kay Holding*, the Fifth Circuit noted that the district court had agreed with Federal Insurance that a "coverage" exception to the "eight corners" rule existed. *Mary Kay Holding*, 309 F. App'x at 848. While the Fifth Circuit affirmed the district court's ultimate ruling, it disagreed with that particular aspect of the district court's opinion, saying: "While appreciating the arguments for a limited 'coverage' exception to the 'eight corners rule,' we recognize that Texas has yet to adopt such an exception." *Id.* (citations omitted). Nevertheless, in August, a separate panel found that deposition testimony could be used in determining an insurer's duty to defend an alleged insured. *See Ooida*, 2009 WL 2461850 at *6. The court said that "[w]e find that *GuideOne* supports our '*Erie* guess' that the limited conditions of an exception to the eight corners rule exists here." *Id.* Ac-

cordingly, it considered extrinsic evidence, found that the evidence triggered an exclusion and ruled that no duty to defend existed. *Id.* Confusion exists among district courts as well. *Compare Sentry Ins. v. DFW Alliance Corp.*, 2007 WL 669418, *2 (N.D. Tex. Mar. 6, 2007) (finding that an exception to the "eight corners" rule, although appealing, has not yet been recognized by the Supreme Court of Texas), *with Roberts, Taylor & Sensabaugh, Inc. v. Lexington Ins. Co.*, 2007 WL 2964445, *2–*6 (S.D. Tex. Oct. 9, 2007) (allowing the use of extrinsic evidence in determining the duty to defend because it did not contradict the merits of the underlying lawsuit). State appellate courts, however, are less inclined to recognize any exception to the "eight corners" rule. *See AccuFleet, Inc. v. Hartford Fire Ins. Co.*, 2009 WL 2961351 (Tex. App.—Houston [1st Dist.] Sept. 17, 2009, no pet. h.) (declining to create an exception to the "eight corners" rule for purposes of determining the duty to defend and noting that the Supreme Court of Texas has not yet recognized any such exception).

Commentary:

The *D.R. Horton* case provides a chance for the Court to clarify when, if ever, extrinsic evidence is admissible at the duty to defend stage. Given the factual similarities between *D.R. Horton* and *Pine Oak*, it will be interesting to see whether or how the Court will craft an exception. It is possible, however, that the Court reversed course in *D.R. Horton* for an entirely different reason. The *D.R. Horton* case, as urged by the amicus curiae, presents the perfect example of a mistaken application of the "if no duty to defend, then no duty to indemnify" rule. The *D.R. Horton* court concluded that no duty to defend existed because the underlying petition failed to specifically mention the use of subcontractors so as to trigger additional insured status. After reaching this conclusion, the court explicitly stated as follows:

> Even though we do not look at the specific legal theories alleged to determine the duty to indemnify, if the underlying petition does not raise factual allegations sufficient to invoke the duty to defend, then even proof of all of those allegations could not invoke the insurer's duty to indemnify. For this reason, the same arguments that disposed of Markel's duty to defend also dispose of its duty indemnify. Because the Holmes suit did not allege facts covered by the policy, even proof of those facts would not trigger coverage. We therefore affirm the trial court's summary judgment in favor of Markel on the issue of Markel's duty to indemnify.

D.R. Horton, 2006 WL 2040756, at *6 (internal citations omitted).[9] The court clearly was wrong in this regard. In particular, as noted in the opinion, D.R. Horton had produced ample summary judgment evidence demonstrating the requisite causal link between the named insured's work and D.R. Horton's liability. Even if such evidence is not admissible at the duty to defend context based on a strict "eight corners" analysis, no valid reason exists to ignore the extrinsic evidence at the duty to indemnify stage. In fact, since the duty to indemnify is based on actual facts, it absolutely is proper for a court to consider extrinsic evidence at the duty to indemnify stage.

The "no duty to defend, no duty to indemnify" rule followed by the appellate court in *D.R. Horton* arguably conflates the duty to defend and the duty to indemnify—the very thing the

[9] While the decision in *Pine Oak* did the same thing, the court of appeals in *D.R. Horton* was much more specific in its holding that a finding of no duty to defend forecloses any potential of a duty to indemnify.

Supreme Court warned against in *GuideOne* and *Pine Oak*. A better stated rule would be: When no duty to defend exists, and no facts can be developed at the trial of the underlying lawsuit to impose coverage, an insurer's duty to indemnify may be determined by summary judgment at the same time as the duty to defend. In effect, the appellate court's ruling in *D.R. Horton* places too much emphasis on the oft-recognized principle that the duty to defend is broader than the duty to indemnify. While that principle is true in most cases, it *does not* hold true in every case. The *D.R. Horton* case provides a perfect example of why.

II. *Trinity Universal Insurance Co. v. Employers Mutual Casualty Co.*

In October of 2007, in what was more a trick than a treat, the Supreme Court of Texas issued its decision in *Mid-Continent Insurance Co. v. Liberty Mutual Insurance Co.*, 236 S.W.3d 765 (Tex. 2007), in which the Court ruled that settling co-primary insurers had neither a right of contribution or a right of subrogation against one another. There, Mid-Continent, while providing a shared defense with Liberty Mutual, vastly under-evaluated the settlement value of the case and the liability of its insured. Accordingly, Mid-Continent refused to provide more than $150,000 toward settlement of the underlying lawsuit. Liberty Mutual, on the other hand, while recognizing the best interest of its insured, agreed to provide more than its policy limits ($1.35 million) to fund the settlement ensuring its insured's release from any further claims. In turn, it sought reimbursement from Mid-Continent such that both insurers would have paid the exact same amount toward settlement. But, despite recognizing that Mid-Continent acted unreasonably, the Court refused to allow Liberty Mutual any recovery.

Although many hoped that the Court's ruling would perhaps fall between the cracks or at least be limited to the particular facts at issue there, alas, those hopes were shaken when the Southern District of Texas extended the *Mid-Continent* holding from its application to the duty to indemnify, making it applicable to an insurer's duty to defend its insured as well. *See Trinity Universal Ins. Co. v. Employers Mut. Cas. Co.*, 586 F. Supp. 2d 718 (S.D. Tex. 2008). Moreover, the *Trinity Universal* case extended *Mid-Continent* to disputes between *consecutive* insurers as opposed to only between concurrent insurers. And, as if to pour salt in the wound, the Southern District extended *Mid-Continent* to apply to an insurer that had actually breached a duty to its insured. These unfortunate extensions have caused significant problems in situations where multiple insurers are triggered (e.g., progressive "property damage" cases).

A. The Background Facts

Lacy Masonry, Inc. ("Lacy Masonry") was the named insured under four CGL policies issued by Plaintiffs Trinity Universal Insurance Company, Utica National Insurance, and National American Insurance Company (collectively, the "Plaintiffs"), and Defendant Employers Mutual Casualty Company ("EMC"). Together the insurers provided insurance to Lacy Masonry from March 25, 2000 to May 14, 2004 and May 16, 2004 to May 16, 2005. Each policy contained identical "other insurance" clauses, providing that when more than one policy applies the insurers contribute on a "pro rata" basis. *Trinity Universal*, 586 F. Supp. 2d at 720.

On November 1, 2005, Lacy Masonry (along with others) was sued in Texas state court by McKenna Memorial Hospital ("McKenna") for damages caused by extensive water infiltration issues, arising out of the construction and improvement of a building. In particular, Lacy

Masonry was alleged to have performed "all masonry work" on the project and other façade items. A co-defendant in that lawsuit allegedly installed an EIFS system on the project. *Id.* at 720–21.

On or before February 2, 2006, Lacy Masonry notified the Plaintiffs and EMC of the underlying lawsuit. Each of the Plaintiffs agreed to defend Lacy Masonry subject to a reservation of rights, but EMC claimed that it had no such duty, refusing to contribute any portion of the defense costs. Instead, those costs were borne entirely by the Plaintiffs. As a result, the Plaintiffs asserted claims against EMC for breach of contract, contribution, and attorney's fees, as well as sought a declaration that EMC had a duty to defend Lacy Masonry against McKenna. The parties cross-moved for summary judgment as to whether the allegations in McKenna's suit were potentially covered by EMC's policy so as to trigger its duty to defend Lacy Masonry, and whether Texas law allows a co-insurer to recover a share of defense costs from another insurer when their policies contain identical "other insurance" clauses. *Id.* at 721.

B. The Duty to Defend Exists

Before reaching a discussion as to the application of *Mid-Continent* to the facts before it, the Southern District of Texas first had to assess whether EMC's duty to defend its insured even was triggered by the allegations in McKenna's pleadings against Lacy Masonry. For two reasons, EMC claimed that no such duty existed: (1) the "designated work" exclusion barred coverage for any claims arising out of a project on which EIFS is applied; and (2) the fortuity doctrine barred coverage for the claims. The court addressed each in turn. *Id.* at 722.

With regard to the "designated work" exclusion, the court noted that the endorsement specifically excluded coverage for "[a]ny work or operations with respect to any exterior component, fixture or feature of any structure i[f] an 'exterior insulation and finish system' is used on any part of that structure.'" *Id.* at 723. On the other hand, the allegations stated that Lacy Masonry performed "all masonry work" on the project and that water infiltration existed, in part, because of improperly installed masonry. As noted, allegations also existed that EIFS had been applied by a different subcontractor. EMC claimed that such allegations made "clear that the only thing Lacy Masonry is being sued for involves exterior components of a structure that incorporate[s] EIFS." *Id.* at 724. The court, however, disagreed. It found that the petition did not allege that "masonry work was performed exclusively on the *exterior* of the building or that there was no masonry work done in the *interior* of the building." *Id.* Because Texas law requires that such allegations be construed in favor of the insured, the court held that EMC was not excused from its defense duty by the "designated work" exclusion. *Id.* at 725.

Turning to the "fortuity doctrine," the court recognized that EMC relied entirely on extrinsic evidence to support its claim that Lacy Masonry was aware of the McKenna loss before its policy incepted on May 16, 2004. *Id.* The court addressed Texas law on the use of extrinsic evidence as to the duty to defend and found that even if the Supreme Court of Texas were to acknowledge an exception to the strict "eight corners" rule, the evidence relied upon by EMC was inadmissible. In particular, the court said that the evidence proffered by EMC "does not fit within this presumed narrow exception to the eight-corners rule." *Id.* at 726. For instance, some of the evidence was developed during litigation of the underlying lawsuit and other evidence overlapped—at least in part—with the merits of McKenna's claims against Lacy Masonry. *Id.* at

726–28. Accordingly, the court found that EMC could not escape its duty to defend its insured. *Id.* at 728.

Or could it . . .

C. Taking *Mid-Continent* Another Step Too Far

After finding that EMC had wrongfully denied a defense to its insured and had breached its contract in doing so, the court addressed whether the Plaintiffs could recover any of the defense costs they had incurred in fully defending the parties' mutual insured. On that issue, EMC argued that the Supreme Court of Texas' decision in *Mid-Continent* precluded the Plaintiffs' from recovering from EMC those costs. Addressing that contention, the Southern District of Texas discussed the intricacies of the *Mid-Continent* decision. *Id.*

First, in *Mid-Continent*, the Court adhered to its longstanding opinion in *Traders & Gen. Ins. Co. v. Hicks Rubber Co.*, 169 S.W.2d 142 (Tex. 1943), and ruled that when two co-insurers have identical "pro rata" or "other insurance" clauses, a contribution claim asserted by one against the other to recoup defense costs was precluded. Second, the Court had found that when an insurer pays more than its pro-rata share under such an "other insurance" clause, its payment is voluntary, also barring it from recovering via a claim for contribution. Third, in addressing Liberty Mutual's subrogation claims, the Court held that an insurer steps into the shoes of its insured in such cases, and that because such an insured—which has been fully indemnified—cannot sue another insurer for subrogation, neither can one co-insurer that seeks to recover from another co-insurer. *Trinity Universal*, 586 F. Supp. 2d at 729.

Applying that case to the facts before it, the Southern District of Texas extended the *Mid-Continent* decision beyond the duty to indemnify context in which it was rendered and incorporated the same logic (or lack thereof) at the duty to defend stage. Addressing the Plaintiffs' claim for contribution first, the court held that the *Hicks Rubber* decision, as analyzed and reaffirmed in *Mid-Continent*, "applies squarely to Plaintiffs' claim for contribution." *Id.* More specifically, the court found that the insurers' policies all contained "other insurance" clauses identical to those addressed in *Mid-Continent*. Because such clauses render the contractual obligations of the Plaintiffs and EMC to their mutual insured "several and independent of each other, not joint . . . Plaintiffs cannot establish the common obligation element of their contribution claim." *Id.* at 730.

In attempting to distinguish themselves from the *Mid-Continent* decision, Plaintiffs argued that their duty to their insured included provision of a "complete defense" not a pro-rata one means that they did not "voluntarily" pay anything over their pro-rata share of expenses. According to the Plaintiffs, "the 'other insurance' language typically found in insurance policies—because it specifically references only 'loss,' *i.e.*, indemnity—does not apply to the duty to defend." The court disagreed, finding that the critical portion of the Supreme Court's decision addressed the impact of "other insurance" clauses on the "commonality of obligation" between co-insurers. The court said:

> *Mid-Continent* categorically bars direct contribution claims between coinsurers whose policies contain "other insurance" clauses by construing their contractual

> obligations as "several and independent of each other." [citation omitted] The independence of these contractual obligations affects not only the duty to indemnify, as discussed in *Mid-Continent, but necessarily applies with equal force to the duty to defend.*

Id. Accordingly, the insurers turned their otherwise shared contractual obligations into independent duties enforceable—if at all—by Lacy Masonry. *Id.*

Finally, the court addressed the Plaintiffs assertion of a subrogation action for breach of contract as a means to recover from EMC its pro-rata share for the cost of defense. Because Lacy Masonry had been fully compensated, though, the court found that *Mid-Continent* precluded any such claim. *Id.* at 730–31. In particular, under the facts before the court, Lacy Masonry had been fully compensated for its defense costs via the Plaintiffs and thus had no claim against EMC for the past defense costs. Thus, the rationale of *Mid-Continent* precluded the Plaintiffs' subrogation claim. *Id.* at 731. The court also rejected the Plaintiffs' argument that EMC's improper denial of a defense for Lacy Masonry meant that Lacy Masonry could have brought a declaratory judgment action on its own to enforce its contractual rights. Such a declaration was not at issue (and besides, the court already had determined that a duty to defend existed on a prospective basis). *Id.* Rather, it is the Plaintiffs' subrogation claim for breach of contract and damages equal to EMC's share of the defense costs that *Mid-Continent* prohibits. In other words, the Plaintiffs can stand in no better position than Lacy Masonry vis-à-vis EMC.

In light of the foregoing, the *Trinity* court ruled that EMC owed Lacy Masonry a defense. Nevertheless, it also ruled that any previously paid defense costs were non-recoverable because the Plaintiffs had no right to any claims for contribution or subrogation—even at the duty to defend stage—in adherence to *Mid-Continent*.

D. Subsequent Applications of the *Mid-Continent* Decision

1. *Maryland Casualty Co. v. Acceptance Indemnity Insurance Co.*

In *Maryland Casualty Co. v. Acceptance Indemnity Insurance Co.*, Case No. A-08-CA-697-SS, slip op. (W.D. Tex. May 14, 2009), Judge Sparks of the Austin Division of the Western District weighed in on the impact of the *Mid-Continent* decision. Like *Trinity Universal*, The case involved a CGL carrier's attempt to recover a share of defense costs and all or part of the settlement amount from another insurance company that covered the same insured in a different policy period. Maryland Casualty argued that *Mid-Continent* did not apply to its contribution claim against Acceptance because the *Mid-Continent* case should be limited to concurrent insurers as opposed to consecutive insurers. Judge Sparks disagreed and granted Acceptance's Motion for Summary Judgment with respect to the contribution claim. Slip Op. at 7. Even so, Judge Sparks did find that Maryland Casualty had a valid subrogation claim against Acceptance. "Unlike the situation in *Mid-Continent*, the 'other insurance' clauses in this case do not bar a claim for contractual subrogation because the policies at issue cannot both provide coverage for the same loss—only one company's policy was in effect at the applicable time." Slip Op. at 8. Moreover, Judge Sparks found it significant that Acceptance had refused to defend or indemnify its insured whereas the insurer in *Mid-Continent* had participated in the defense. In concluding that Maryland Casualty's subrogation claim against Acceptance could proceed, Judge Sparks

wisely noted: "If [Acceptance's interpretation of *Mid-Continent*] were to become the law, insurance companies would have a large incentive to deny coverage in every case and no insurance company would honor the provisions of its policies whenever any other insurance company could potentially share liability." Slip op. at 10. Notably, in reaching his decision, Judge Sparks did not address *Trinity Universal* in any way.

2. *Duininck Brothers, Inc. v. Howe Precast, Inc.*

In *Duininck Brothers, Inc. v. Howe Precast, Inc.*, 2008 WL 4372709 (E.D. Tex. Sept. 19, 2008), the court ruled that *Mid-Continent* did *not* preclude a claim based on the facts before it. In particular, after noting that "*Mid-Continent* is a narrow case," the court focused on the difference between contractual liability coverage and additional insured status. Notably, because of a valid indemnity agreement, the court concluded that only one insurer was obligated to fund the liability in the underlying lawsuit. Moreover, in contrast to *Mid-Continent*, the insured had not yet been fully indemnified. *Id.* at 9.

3. *Lexington Insurance Co. v. Chicago Insurance Co.*

Nevertheless, other court decisions fully adhere to the principles espoused in *Mid-Continent*. On August 8, 2008, Judge Lee Rosenthal of the Southern District of Texas applied the concepts embodied in that case in her decision in *Lexington Insurance Co. v. Chicago Insurance Co.*, 2008 WL 3538700 (S.D. Tex. Aug. 8, 2008), denying a claim by one insurer against another. The case involved consecutive primary professional liability policies. Both insurers paid to defend the insured and an employee of the insured in connection with a medical malpractice lawsuit. Moreover, each insurer contributed half the amount needed to settle the claims against the insureds. The issue before the court was whether Lexington could obtain reimbursement from the other insurer, Chicago, on the ground that the Lexington policy did not in fact cover the underlying lawsuit. Relying on *Mid-Continent*, Judge Rosenthal concluded that Lexington had no claim for contribution or subrogation against Chicago. *Id.* at 21. In addition, the court rejected the argument that the nonwaiver agreement altered the result by holding that the "nonwaiver agreement does not create an independent contractual obligation between Lexington and Chicago for reimbursement." *Id.* In other words, "[t]he agreement does not create independent rights between Lexington and Chicago, but instead only reserves any rights the parties already had under their policies and applicable law." *Id.*

4. *XL Insurance America, Inc. v. TIG Specialty Insurance Co.*

Five days later, the Northern District of Texas applied *Mid-Continent* in rejecting a claim for equitable subrogation in *XL Insurance America, Inc. f/k/a Winterthur International America Insurance Co. v. TIG Specialty Insurance Co.*, Civil Action No. 3:07-CV-01701 (N.D. Tex. Aug. 13, 2008). There, XL Insurance Company and TIG Specialty Insurance Company provided primary and excess insurance coverage, respectively, to Electric Mobility. XL settled a claim on its insured's behalf for $180,000, not realizing that at that time only $54,930.92 remained available under its policy because of prior settlements. As such, it sought reimbursement from TIG for the $125,069.08 it paid outside of its primary limits, but TIG refused. Thus, XL filed suit against TIG seeking reimbursement via claims of contractual and equitable subrogation. In that lawsuit, on TIG's motion to dismiss under Federal Rule of Civil Procedure 12(b)(6), the Northern District

sided with TIG. After outlining the proof necessary to establish equitable subrogation, the court noted that XL had to show that its payment was involuntary, including that its miscalculation of its remaining policy limits was reasonable. The court held that XL could not establish such reasonableness. In doing so, the court said that the Supreme Court's recent decision in *Mid-Continent* supported the equities of its decision on the matter. In particular, the Northern District relied on the following language from the Supreme Court's opinion:

> [E]quity does not favor such a remedy. A reasonable primary insurer, which did not improperly handle the claim, would not pay more than its policy limits. In paying $350,000 more than its $1,000,000 policy limits, Liberty Mutual seems to have been motivated by concern for its excess insurance policy.

Slip op. at 8 (citing *Mid-Continent*, 236 S.W.3d at 776). That approach, the Northern District said, "causes the Court to reject XL's equitable subrogation claim." *Id.* The court also rejected any contractual subrogation claim, finding that XL's payment outside of its policy limits was not "made under this Coverage Part" as required by its contractual subrogation provision. Slip op. at 10–11. As a result, the court granted TIG's motion to dismiss the contractual and equitable subrogation claims.

5. *Nautilus Insurance Company v. Pacific Employers Insurance Company*

In *Nautilus Insurance Co. v. Pacific Employers Insurance Co.*, No. G-04-619 (S.D. Tex. February 25, 2008), the court granted summary judgment against an insurer seeking to enforce identical pro-rata sharing provisions contained in multiple primary insurance policies. In particular, in *Nautilus*, several insurers were called on to defend and indemnify a seismic testing company that allegedly damaged over 200 buildings in Galveston County while conducting seismic testing. Pacific Employers was the only insurer that refused to contribute to the settlement. Nautilus Insurance, who was one of the participating insurers, sought to recover from Pacific Employers by way of subrogation and enforcement of the policies respective pro-rata "other insurance" clauses. The court, relying on *Mid-Continent*, rejected the claim. More specifically, because the insured had been fully indemnified, the court noted that "there is nothing to which Plaintiff can be subrogated."

Subsequently, the Fifth Circuit affirmed the decision of the district court. *See Nautilus Ins. Co. v. Pacific Employers Ins. Co.*, 303 Fed. App'x. 201 (5th Cir. 2008). In doing so, the Fifth Circuit held: "The Texas Supreme Court was not ambiguous in *Mid-Continent*, and the holding in that case applies with equal force here. Given that EOG was fully indemnified, it has no rights to enforce against Pacific, and thus Nautilus has no right of subrogation against Pacific." *Id.* at 207.

Commentary:

A bad decision in *Mid-Continent* was made worse by the Southern District of Texas' opinion in *Trinity Universal*. While *Mid-Continent* perhaps enabled one insurer to stall settlement negotiations, the threat of continued defense costs at least acted somewhat as a mitigating factor. Now, in light of the *Trinity Universal* decision, a recalcitrant insurer is not punished by simply refusing to defend. Accordingly, the decision—if left intact—creates a disincentive for

insurers to provide a defense when another insurer has stepped up to the plate. Oral argument was held in the Fifth Circuit on August 31, 2009. Amicus briefs filed by both policyholders and insurers urged the Fifth Circuit to reverse the district court decision. While the Fifth Circuit cannot do anything about *Mid-Continent*—at least with respect to its application to the duty to indemnify—the Fifth Circuit can keep a bad decision from getting worse by refusing to extend it to the duty to defend.

III. *Underwriters at Lloyd's of London v. Gilbert Texas Construction, L.P.*

Policyholders and insurers alike often struggle with the scope of the "contractually assumed liability" exclusion. In 2007, the Dallas Court of Appeals weighed in on the application of the exclusion and, in doing so, mistakenly equated the exclusion to a "breach of contract" exclusion. Now, the Supreme Court of Texas has an opportunity to clear the muddied waters in *Underwriters at Lloyd's of London v. Gilbert Texas Construction, L.P.*, 245 S.W.3d 29 (Tex. App.—Dallas 2007, pet. granted).

A. Background Facts

In 1993, the Dallas Area Rapid Transit Authority ("DART") hired Gilbert Texas Construction, L.P. ("Gilbert") as the general contractor for the construction of a commuter rail system in Dallas, Texas. The parties entered into a contract in which their responsibilities were outlined, including, but not limited to, Gilbert's responsibilities with respect to inspection and maintenance of the construction areas and the protection of property belonging to third parties. The contract, by way of example, required Gilbert to "preserve and protect all structures . . . on or adjacent to the work site . . . ." *Gilbert*, 245 S.W.3d at 31.

On May 5, 1995, Dallas experienced unusually heavy rains. At the time, Gilbert was preparing the area in front of a complex of buildings owned by RT Realty, L.P. ("RT Realty") for the installation of rail lines. According to RT Realty, DART and Gilbert had implemented a "storm water pollution prevention plan" that limited the capacity of the storm water drainage inlets in the area around its buildings. Additionally, RT Realty alleged that large piles of dirt, barricades, temporary structures, and construction debris had been left by DART and Gilbert, causing the rain water to be diverted toward RT Realty's buildings and allegedly causing substantial flooding and damage to RT Realty's property. *Id.* at 32.

RT Realty filed a lawsuit against DART, Gilbert, and others alleging claims including violations of the Texas Transportation Code, violation of the Texas Water Code, nuisance, and trespass. In its lawsuit, RT Realty claimed that it was a third-party beneficiary of the contract between DART and Gilbert and, further, that it was damaged by Gilbert's purported breach of contract. *Id.*

Gilbert's primary insurer, Argonaut Insurance Company, defended Gilbert in the litigation without even reserving its rights. Its excess insurer, Underwriters at Lloyd's of London ("Underwriters"), issued several reservation of rights letters outlining its position as to indemnity coverage for the RT Realty lawsuit. In particular, with regard to the breach of contract claim, Underwriters questioned whether a breach of contract constituted an "occurrence" as that term is defined under the Underwriters' policies. During the underlying litigation, and while maintaining

the position that a breach of contract did not constitute an "occurrence," Underwriters insisted that Gilbert move for summary judgment, asserting a lack of subject matter jurisdiction by virtue of governmental immunity. The trial court concluded that Gilbert was entitled to governmental immunity by virtue of its contract with DART and that RT Realty had failed to state tort claims that fell within the limited waiver of governmental immunity permitted by the Texas Tort Claims Act. Accordingly, the trial court signed an order granting Gilbert's motion for summary judgment based on governmental immunity and dismissed all of the claims against Gilbert *with the exception of* the breach of contract claim. *Id.*

Approximately three weeks later, Underwriters issued a new letter in which it claimed that there was "no coverage for the breach of contract claims against Gilbert" because (i) the primary policy had an exclusion for property damage for which the insured is obligated to pay damages because of the assumption of liability in a contract or agreement; (ii) the excess policy excludes coverage for failure to perform obligations under a contract; (iii) the excess policy covers only tort liability, not liability for breach of contract; and (iv) a breach of contract does not constitute an "occurrence." *Id.*

Subsequent to receiving Underwriters' letter, Gilbert settled the breach of contract claim with RT Realty. And, despite the fact that Gilbert's primary insurer had tendered its full policy limits, Underwriters refused to indemnify Gilbert for any portion of the damages Gilbert paid in settlement. *Id.*

B. The Declaratory Judgment Action and Appellate Court Decision

As a result, Gilbert filed the instant action against Underwriters alleging, *inter alia*, claims for breach of contract, violations of the Texas Insurance Code, and waiver and estoppel. Gilbert and Underwriters cross-moved for summary judgment on the issue of coverage and the breach of contract claim. The trial court denied Underwriters' motion and granted Gilbert's, concluding that coverage existed under the excess policies. Gilbert recovered the amount it paid to RT Realty to settle the underlying lawsuit and also recovered attorneys' fees, pre-judgment interest and post-judgment interest. The trial court, however, dismissed Gilbert's claims for waiver and estoppel, as well as Gilbert's claims for violations of the Texas Insurance Code. *Id.* at 32–33.

On appeal, Underwriters argued that the trial court erred because no coverage existed for the breach of contract claim. On cross-appeal, Gilbert alleged that the trial court erred in failing to hold that Underwriters had waived its policy defenses or was estopped from denying coverage under the excess policies. Gilbert also contended that the trial court erred by granting summary judgment in favor of Underwriters in connection with the claims under the Texas Insurance Code. *Id.* at 33.

At the outset, the court of appeals noted that the excess liability policies at issue were "following form" policies, thus providing the same coverage as the primary policies. Contained within the primary policy was an exclusion for "contractually assumed liability," which provides that coverage does not exist for "bodily injury or property damage for which the insured is obligated to pay damages by reason of the assumption of liability in a contract or agreement." *Id.* at 34. The court of appeals found that the exclusion applied on its face because the claims against

Gilbert in the underlying action "were based on Gilbert's assumption of liability in its contract with DART to repair property damage to third-party property." *Id.*

The appellate court, with barely any discussion of the exclusion itself, then turned to one of the two exceptions to the exclusion that provides that the exclusion does not apply to liability for damages "that the insured would have in the absence of the contract or agreement." *Id.* Gilbert claimed that the claims against it fit squarely into that exception. *Id.* The court of appeals disagreed. It found that "[w]here the contract adds nothing to the insured's liability and the liability assumed under the contract is coextensive with the insured's liability under the law, the exclusion does not apply." *Id.* And, although, the court recognized that the liability Gilbert assumed under the contract could be classified as general tort liability, the court could not "say that the contract adds nothing to Gilbert's liability under the law." *Id.* The court noted that the trial court had found that Gilbert was immune from tort liability, so its only liability arose by virtue of what it assumed under the contract with DART. In other words, the court said:

> But for the contract, all claims made by RT Realty against Gilbert would have been barred by governmental immunity. Gilbert assumed liability under the contract that it would not have had under the law. The exception, therefore, does not apply. The exclusion bars coverage.

Id. at 34–35.

The court of appeals rejected Gilbert's contention that the word "liability" should be construed to include both adjudicated and unadjudicated liability such that Gilbert's alleged tort liability—before being resolved by adjudication—would be compared to the liability assumed under the DART contract for purposes of determining the application of the exception. In particular, the court found that "[t]his comparison would render Gilbert's immunity from tort liability of no consequence to the determination of whether the exception applies because Gilbert's potential liability before the resolution of its immunity defense would be sufficient to trigger the exception." *Id.* at 35. This, the court found, means that allegations of liability rather than liability established through judgment or settlement would control an insurer's duty to indemnify under the exception in contravention of the longstanding rule that indemnification under an insurance contract does not accrue until the indemnitee's liability becomes fixed and certain. *Id.*

The appellate court also dismissed Gilbert's contention that applying the exclusion in the instant case creates an irreconcilable conflict between an insurer and its insured because the successful assertion of an affirmative defense to a tort claim causes the previously covered contract claim to be outside the scope of insurance coverage. *Id.* The court said that "such conflicts arise frequently in insurance cases, and it is common that insurance coverage depends upon the adjudicated basis for the insured's liability. . . . Such a conflict cannot form the basis for coverage where coverage does not exist under the plain language of the policy." *Id.*

As an alternative argument, Gilbert asked the appellate court to preclude the Underwriters from denying coverage under the doctrines of waiver and estoppel. *Id.* While normally such doctrines cannot be used to create coverage, an exception exists when the insurer assumes the defense of its insured without a reservation of rights and with knowledge of facts indicating that

no coverage exists. *Id.* at 35–36.[10] In particular, Gilbert asserted that the Underwriters assumed its defense by pressuring it to seek summary judgment on the immunity issues without notifying Gilbert of the coverage position the Underwriters would take if summary judgment were granted. In fact, Gilbert presented testimony that the Underwriters informed it that if it did not move forward on the summary judgment, the Underwriters would deny coverage under the cooperation clause of the insurance policy. *Id.* at 36. Nevertheless, the court disagreed, finding that the Underwriters' actions did not amount to an assumption of the defense of Gilbert, as Gilbert's primary insured assumed that defense and asserted the defense of governmental immunity without any consultation from the Underwriters. *Id.* Moreover, the court found that the Underwriters had the ability to "associate with" the defense without being found to have "assumed" the defense under the policy's cooperation clause. And, it said that Gilbert could have resisted the alleged pressure as to the summary judgment motion and fought the Underwriters on any denial of coverage under the cooperation clause, as that would not have affected Gilbert's defense in the underlying suit, which was being provided by its primary insurer. *Id.* Because the appellate court found that the Underwriters had not assumed responsibility for Gilbert's defense, the court found that the insurer had not waived its defenses and was not estopped from raising the defense of non-coverage. *Id.* at 37.

Accordingly, the court of appeals reversed the trial court's holdings, finding that RT Realty's claim for breach of contract against Gilbert fell within the "contractually assumed liability" exclusion. And, as such, the court of appeals determined that Underwriters was not obligated to indemnify Gilbert for the settlement monies it paid to RT Realty. *Id.*

C. Petition for Review to the Supreme Court of Texas

1. The "Contractually Assumed Liability" Exclusion is Inapplicable

Gilbert filed a petition for review with the Supreme Court of Texas on April 2, 2008. It raised three issues for the Court to address: (i) the appellate court erred in applying the "contractually assumed liability" exclusion to negate coverage; (ii) even if the appellate court correctly concluded that the exclusion applied, it erred when it failed to apply the express exception for liability the insured would have in the absence of the contract or agreement; and (iii) the appellate court erred in concluding that Underwriters was not estopped from raising coverage defenses.[11]

Regarding the first issue, Gilbert argued that Underwriters misleadingly asserted, and the court of appeals mistakenly concluded, that the "contractually assumed liability" exclusion bars a breach of contract claim. In fact, Texas precedent makes clear that the "contractually assumed liability" exclusion is *not* a breach of contract exclusion. Rather, by its plain language, the exclu-

[10] Importantly, when the case was before the appellate court, Gilbert's waiver and estoppel argument was premised on what was then known as the "*Wilkinson* exception" to the general rule that waiver and estoppel cannot create coverage where none exists. The "*Wilkinson* exception," however, was abrogated by the Supreme Court of Texas' decision in *Ulico Casualty Co. v. Allied Pilots Association*, 262 S.W.3d 773 (Tex. 2008).

[11] In the interest of full disclosure, the author represents Gilbert in its appeal to the Supreme Court. So, if the remainder of this discussion sounds argumentative, it probably is.

sion addresses situations when an insured assumes the liability of another for claims by a third party. The Fifth Circuit, in interpreting identical policy language, stated:

> This exclusion operates to deny coverage when the insured assumes responsibility for the conduct of a third party. As GEI is not being sued as the contractual indemnitor of a third party's conduct, but rather for its own conduct, the exclusion is inapplicable. Moreover, even if the contractual liability exclusion were somehow applicable to situations in which the insured is being sued for its own conduct, the exclusion would not apply here. It is true, as Maryland notes, that under the subcontract between GEI and T&S, GEI agreed to indemnify T&S and hold it harmless for claims arising both from conduct of specified third parties and from its own conduct.
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> ***
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> This indemnity provision is not, however, the only source of GEI's duty to T&S. Even absent a contractual indemnity provision, GEI would be liable to T&S—under generally applicable contract law—for damage caused by GEI's negligent failure to perform its contractual duties according to the specifications of the subcontract.
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> ***
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> When, as here, liability could be imposed pursuant to either a contractual indemnity provision or a generally applicable legal principle, the contractual liability exclusion will not bar coverage.

Federated Mut. Ins. Co. v. Grapevine Excavation, Inc., 197 F.3d 720, 726–27 (5th Cir. 1999). The Fifth Circuit's logic has been followed consistently by other courts within Texas. *See E&R Rubalcava Constr., Inc. v. Burlington Ins. Co.*, 147 F. Supp. 2d 523, 528 (N.D. Tex. 2000) (holding that the "contractually assumed liability" exclusion does not apply even though the claimant sued the insured for breach of contract because the liability was based on the insured's own conduct); *Home Owners Mgmt. Enters., Inc. v. Mid-Continent Cas. Co.*, 2005 WL 2452859 (N.D. Tex. Oct. 3, 2005) (noting that the "contractually assumed liability" exclusion only applies when the insured assumes responsibility for the conduct of another as opposed to when the insured is liable in contract for its own conduct), *aff'd* 294 F. App'x 814 (5th Cir. Aug. 26, 2008);[12] *Ins. Co. of N. Am. v. McCarthy Bros. Co.*, 123 F. Supp. 2d 373, 377 (S.D. Tex. 2000) (holding that "assumption of liability" exclusion did not preclude coverage for insured builder's agreement through settlement to repair damage caused by its faulty construction because insured accepted liability for its own conduct—not liability of another); *Lennar Corp. v. Great Am. Ins. Co.*, 200 S.W.3d 651, 693 (Tex. App.—Houston [14th Dist.] 2006, pet. denied) ("Exclusion B(2) precludes coverage when the insured contractually assumes liability for the conduct of a third party such as through an indemnity or hold harmless agreement.").

[12] In its opinion, the Fifth Circuit found that even if the "contractually assumed liability" exclusion applied—which it said was "not without doubt given our and other courts' construction of it and similar exclusions"—an exception to the exclusion applied. *See Home Owners Mgmt. Enters., Inc. v. Mid-Continent Cas. Co.*, 294 F. App'x 814, 820 (5th Cir. Aug. 26, 2009).

The vast majority of courts outside of Texas also agree with this view. The most notable example is from the Wisconsin Supreme Court. *See Am. Family Mut. Ins. Co. v. Am. Girl, Inc.*, 673 N.W.2d 65 (Wis. 2004). In *American Family Mutual*, the Wisconsin Supreme Court reversed an appellate court that—like the court of appeals here—had applied the identical "contractually assumed liability" exclusion to a breach of contract claim against an insured:

> The term "assumption" must be interpreted to add something to the phrase "assumption of liability in a contract or agreement." Reading the phrase to apply to all liability sounding in contract renders the term "assumption" superfluous. We conclude that the contractually-assumed liability exclusion applies where the insured has contractually assumed the liability of a third party, as in an indemnification or hold harmless agreement; it does not operate to exclude coverage for any and all liabilities to which the insured is exposed under the terms of the contracts it makes generally.
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> ***
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> Limiting the exclusion to indemnification and hold-harmless agreements furthers the goal of protecting the insurer from exposure to risks whose scope and nature it cannot control or even reasonably foresee. The relevant distinction "is between incurring liability as a result of breach of contract and specifically contracting to assume liability for another's negligence."

Id. at 81 (internal citations omitted). Other cases are in accord with this view as well. *See, e.g.*, *ACUITY v. Burd & Smith Constr., Inc.*, 722 N.W.2d 33, 40 (N.D. 2006); *Marlin v. Wetzel County Bd. of Educ.*, 569 S.E.2d 462, 469 (W. Va. 2002); *Gibbs M. Smith, Inc. v. U.S. Fid. & Guar. Co.*, 949 P.2d 337, 342 (Utah 1997); *Olympic, Inc. v. Providence Washington Ins. Co.*, 648 P.2d 1008, 1011 (Alaska 1982); *Broadmoor Anderson v. Nat'l Union Fire Ins. Co.*, 912 So.2d 400, 406–07 (La. Ct. App. 2005). Simply put, and as recognized by all of these courts and others, the liability of another must be assumed in order for the exclusion to apply in the first instance. Otherwise, the phrase "assumption of liability" in the exclusion has no meaning.

Leading commentators also are in accord with this view. As an example, one well-known commentator specifically states: "The CGL coverage for a policyholder's liability assumed by contract 'refers to liability incurred when one promises to indemnify or hold harmless another, and does not refer to liability that results from breach of contract.'" 2 JEFFREY W. STEMPEL, STEMPEL ON INSURANCE CONTRACTS § 14.14 (3d ed. 2005 & Supp. 2008) (internal citations omitted). *See also* 2 ALAN D. WINDT, INSURANCE CLAIMS & DISPUTES § 11.7 (5th ed. 2007 & Supp. 2008) ("The foregoing policy provision refers to certain indemnity and hold harmless agreements. And it refers to an underlying tort liability that was assumed, not to an underlying contractual liability."); SCOTT C. TURNER, INSURANCE COVERAGE OF CONSTRUCTION DISPUTES § 10:1 (2d ed. 1999 & Supp. 2007) ("While the term 'contractual liability' coverage is well established in the jargon of those dealing with CGL coverage, one must approach this subject with the knowledge that this term is highly deceptive and has led to many misunderstandings . . . . In any event, the term 'contractual liability' does not include the insured's liability in contract other than its contractual 'assumption' of *another's* liability.") (emphasis added); BARRY R. OSTRAGER & THOMAS R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES § 7.05 (14 ed. 2007 & Supp. 2008) ("Thus, courts have consistently interpreted the phrase 'liability assumed by the in-

sured under any contract' to apply only to indemnification and hold-harmless agreements, whereby the insured agrees to 'assume the tort liability of another.' This phrase does not refer to the insured's breaches of its own contracts."). *See generally* LEE R. RUSS & THOMAS F. SEGALLA, COUCH ON INSURANCE § 129.31 (3d ed. 1995 & Supp. 2007); Rowland H. LONG, THE LAW OF LIABILITY INSURANCE § 10.05[2], 10-56, 10-57 (2002); 21 ERIC MILLS HOLMES, APPLEMAN ON INSURANCE § 132.3, at 36–37 (2d ed. 2002). And, in the most recent update of the Bruner & O'Connor treatise, the authors specifically point to the *Gilbert* case as an example of a misapplication of the "contractually assumed liability" exclusion. 4 PHILIP L. BRUNER & PATRICK J. O'CONNOR, JR., BRUNER & O'CONNOR ON CONSTRUCTION LAW § 11:52 (2009) (discussing the appellate court's erroneous application of the exclusion).

No dispute exists that Gilbert was sued directly for its own purported breach of contract. In fact, in the opening paragraph of the opinion, the court of appeals states that "[t]he controlling issue we decide is whether there is coverage under the policies for damage allegedly caused by the insured's breach of a contractual duty." *Gilbert*, 245 S.W.3d at 31. While the issue was framed correctly, the court of appeals mistakenly equates damage to a third party for which a contract breach is claimed with a claim based on the contractual assumption of the liability of a third party. *See Musgrove v. Southland Corp.*, 898 F.2d. 1041, 1044 (5th Cir. 1990) ("The assumption by contract of the liability of another is distinct conceptually from the breach of one's contract with another. Liability on the part of the insured for the former is triggered by contractual performance; for the latter liability is triggered by contractual breach.") (citations omitted). It is only a contractual *assumption* of the liability of another to a third party that falls within the scope of the exclusion. Had Gilbert assumed DART's liability to RT Realty and had Gilbert been sued based on its assumption of DART's liability, then perhaps the "contractually assumed liability" exclusion would have applied. But those were not the facts presented to the appellate court. Gilbert *did not* assume DART's liability, and Gilbert was not sued for any assumption of DART's liability to RT Realty. Rather, it is undisputed that RT Realty sued Gilbert directly for Gilbert's own purported breach of contract.

Aside from simply misapplying the exclusion, the court of appeals opinion that a breach of contract claim falls within the "contractually assumed liability" exclusion effectively eviscerates the Supreme Court's opinion in *Lamar Homes*. Notably, the Court went to great lengths in concluding that "the CGL policy makes no distinction between tort and contract damages." *Lamar Homes*, 242 S.W.3d at 13. The Supreme Court's opinion in *Lamar Homes*, as well as the numerous cases that came before and were pending with it, would have been completely unnecessary if the CGL policy already excluded breach of contract claims.

And, in fact, certain CGL carriers have added specific "breach of contract" exclusions to their policies. *See B. Hall Contracting, Inc. v. Evanston Ins. Co.*, 447 F. Supp. 2d 634, 643 (N.D. Tex. 2006), *rev'd on other grounds by* 2008 WL 942937 (5th Cir. 2008) (applying an express "breach of contract" exclusion); *Essex Ins. Co. v. Patrick*, 2006 WL 3779812 (W.D. Tex. Oct. 16, 2006) (same). *See also Carolina Cas. Ins. Co. v. Sowell*, 603 F. Supp. 2d 914 (N.D. Tex. 2009) (addressing the application of an exclusion precluding coverage for claims "based upon, arising out of, directly or indirectly resulting from or in consequence of, or in any way involving any oral or written contract or agreement"). Certainly, such exclusions would be wholly unnecessary if the "contractually assumed liability" exclusion already excluded breach of contract claims. Moreover, one only needs to look at Coverage B of the standard ISO policy to see that it

contains *both* a "contractually assumed liability" exclusion and a "breach of contract" exclusion. Again, and in violation of well-settled contract interpretation rules, the breach of contract exclusion would be mere surplusage if the "contractually assumed liability" exclusion already excluded breach of contract claims.

2. In Any Event, the Exception to the Exclusion Is Applicable

The court of appeals correctly recognized that the "contractually assumed liability" exclusion contains an exception for "liability that would exist in the absence of the contract or agreement." *See Gilbert*, 245 S.W.3d at 34. The court of appeals, however, after mistakenly concluding that the exclusion applied in the first place, held that the exception did not apply because Gilbert's liability to RT Realty did not exist other than by its contract. *See id*. The court of appeals was wrong.

More specifically, the court of appeals failed to recognize *why* Gilbert was cloaked with governmental immunity protection in the first place—its contract with DART. Consequently, it is clear that but for Gilbert's contract with DART, Gilbert would have had common law tort liability to RT Realty for the damages allegedly caused by Gilbert to the neighboring property owned by RT Realty. Thus, Gilbert's liability to RT Realty is one Gilbert "would have in the absence of a contract or agreement." Therefore, assuming the exclusion even applies, the exception to the "contractually assumed liability" exclusion negates the application of the exclusion to the instant set of facts.

3. Waiver and Estoppel in Light of *Ulico*

As previously mentioned above, Gilbert also argued in the appellate court that Underwriters waived or should be estopped from raising its defense of no coverage under what used to be known as the "*Wilkinson* exception." *See Gilbert*, 245 S.W.3d at 35–36 (discussing *Farmers Tex. County Mut. Ins. Co. v. Wilkinson*, 601 S.W.2d 520, 521–22 (Tex. Civ. App.—Austin 1980, writ ref'd n.r.e.)). The crux of Gilbert's alternative argument was that Underwriters had assumed control of Gilbert's defense in the Underlying Lawsuit by threatening to pull coverage via the cooperation clause unless Gilbert filed a motion for summary judgment on the sovereign immunity ground. It is important to note, however, that Underwriters *had not* reserved rights based on the "contractually assumed liability" exclusion and the underlying carrier had defended without any reservation of rights. *Id.* at 36.

While the petition for review was pending before the Supreme Court, the Court decided *Ulico Cas. Co. v. Allied Pilots Association*, 262 S.W.3d 773 (Tex. 2008), in which the Court held that an insured's coverage could not be expanded by waiver and estoppel. Accordingly, in its brief on the merits Gilbert modified its argument to fit within the rubric of *Ulico*, contending that Underwriters assumed or asserted control over its defense in a manner that prejudiced Gilbert and that Underwriters did so without providing a reservation of rights identifying the "contractually assumed liability" exclusion on which it ultimately relied on to deny coverage. The estoppel argument is an alternative argument that only will come into play if the Court rules that Underwriters' interpretation of the "contractually assumed liability" exclusion is correct.

Commentary:

Confusion arising from the applicability of the "contractually assumed liability" exclusion is nothing new to insurance coverage law. The Supreme Court of Texas, however, now has an opportunity to clarify the application of the exclusion, much as the Fifth Circuit did in *Grapevine Excavation.*[13] Quite simply, as recognized by a majority of courts and commentators, the exclusion is not a "breach of contract" exclusion. Rather, it applies only when the insured contractually assumes the liability of a third party.[14]

In reaching its holding, the court of appeals necessarily suggests that coverage is dependent on the viability of a tort claim against Gilbert. In stark contrast, the Supreme Court of Texas has held that liability defenses do not equate with coverage defenses. *See Lamar Homes*, 242 S.W.3d at 13 (rejecting the economic loss doctrine as a defense to coverage). Likewise, in *Lamar Homes*, the Court re-emphasized the long-standing principle that the label attached to a cause of action does not determine insurance coverage. *See id*. Given that precedent, the court of appeals' decision has the effect of impermissibly barring coverage, for example, in every instance in which the economic loss rule prevents contracting parties from suing one another in tort. Not only does such a result find no support in the actual policy language, but also it defeats a main function of CGL coverage for contractors (i.e., to cover "property damage" to a third party caused by the work of an insured or its subcontractors).

Oral argument was held before the Court on October 6, 2009.

[13] On first blush, a new case from the Fifth Circuit appears to support the argument that a breach of contract is excluded by the "contractually assumed liability" exclusion. *See Century Surety Co. v. Hardscape Const. Specialties, Inc.*, 2009 WL 2413935 (5th Cir. 2009). Upon closer examination, however, it is clear that the *Century Surety* case does not stand for that proposition. In particular, in *Century Surety*, the parties stipulated that the exclusion applied and the entire issue on appeal was whether an *exception* for assuming the *tort* liability of another applied to the facts of the case. *See Century Surety*, 2009 WL 2413935 at *3 n.2. Moreover, in *Century Surety*, a general contractor was attempting to recover under a subcontractor's policy for the subcontractor's assumption of the general contractor's liability to the owner. *Id.* at *1. Accordingly, the court properly focused on whether an exception to the exclusion applied. As further evidence that the court's opinion does not stand for the proposition that breaches of contract are excluded by the "contractually assumed liability" exclusion, the Fifth Circuit did not overrule—let alone even address—*Grapevine Excavation* or any of the other cases that address the scope of the exclusion itself.

[14] And, even then, the "contractually assumed liability" exclusion does not apply to certain contractual assumptions as defined by the term "insured contract" within the CGL policy. By way of example, the exclusion does not apply if the insured "assumes the tort liability of another."