

***A PRIMER ON WHAT EVERY CONSTRUCTION LAWYER
SHOULD KNOW ABOUT INSURANCE***

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by Lee H. Shidlofsky¹

I. SCOPE OF PAPER

This paper provides a primer on important issues involving insurance coverage in the construction defect context. Despite the Supreme Court of Texas' comment that insurance policies should be written in plain English and not code, the interpretation of insurance policies and the application of policy terms to construction defect claims oftentimes is complex. This paper is designed to provide an introduction to important insurance issues faced by construction lawyers in construction defect litigation.

Several types of policies come into play in the context of defective construction losses. The most common are: (i) **commercial general liability (CGL) policies**; (ii) **builder's risk policies**; (iii) **excess and umbrella policies**; and (iv) **errors and omissions policies**.² This paper begins with an examination of the structure of the CGL policy and its key components. Then certain issues involved in representing policyholders in construction-related cases are discussed.

II. TYPES OF POLICY COVERAGE IN THE CONSTRUCTION LAW CONTEXT

Insurance policies generally provide either first or third-party coverage, although some types of policies will contain both coverages (e.g., a homeowners policy). **First-party coverage** protects the insured and the insured's assets against loss or damage. Stated differently, a first-party claim is one in which an insured seeks recovery for the insured's own loss. *See Hartman v. St. Paul Fire & Marine Ins. Co.*, 55 F. Supp. 2d 600, 603 (N.D. Tex. 1998); *Universe Life Ins. Co. v. Giles*, 950 S.W.2d 48, 53 n.2 (Tex. 1997). Examples of first-party coverage include property insurance (like the builder's risk policy discussed below), health insurance, life insurance, disability insurance, and fire insurance. **Third-party coverage**, in contrast, provides coverage for claims made against the insured by third parties for injuries to the third party or damage to the third party's property. Examples of third-party coverage include the CGL policy, directors' and officers' liability policies, and errors and omissions policies (e.g., architects and engineers).

A. CGL Policies

CGL policies serve as a general-purpose foundation for the insured's liability or third-party coverage. The standard CGL policy is best known for the defense and indemnity coverage it provides for "bodily injury" and "property damage." Additionally, although not as frequently encountered on construction projects, CGL policies also provide coverage for certain specified offenses under the "advertising and personal injury" coverage. CGL policies are the primary means of insurance protection for third-party claims for any insured business, including owners, developers, and contractors.

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² A glossary of all bold-face terms is provided in the appendix.

B. Builder's Risk Policies

The major means to insure property exposures on a construction site is through first-party property insurance. Builder's risk is first-party insurance that is designed to protect against the risk a builder and/or owner faces when constructing, repairing, or renovating a structure. In *Data Specialties, Inc. v. Transcontinental Insurance Co.*, 125 F.3d 909 (5th Cir. 1997), the court noted:

The CGL policy covers the contractor for its tort liability. Builders' risk insurance, however, provides property insurance for a project under construction. This coverage reimburses the owner, or any party with an insurable interest such as a mortgage holder, for the accidental loss, damage, or destruction of the property, regardless of fault. Builders' risk is not permanent insurance. It is usually issued to insure a building only during the course of the construction period and perhaps for a short additional period after the construction is completed.

Id. at 913 (citations omitted). In other words, builder's risk coverage protects an insured from loss to property in which it has an insurable interest. The coverage period will be defined in the policy—although it typically extends from the point in time when construction begins to the time when the construction or repair is “completed” or the building is “occupied.” Builder's risk policies, however, are not standard. Accordingly, it is not unusual to have coverage terminate upon a certain event (e.g., acceptance of the building by the buyer).

The distinction between first-party coverage provided under a builder's risk policy and third-party coverage provided under a CGL policy often overlap. As one commentator stated:

In many instances, the line between builders risk and CGL coverage blurs. A CGL insurance policy may provide coverage for a contractor that either coincides with, or is excess of, coverage provided under the builders risk policy. This is particularly the case for defective work.

PATRICK J. WIELINSKI, INSURANCE FOR DEFECTIVE CONSTRUCTION CH. 1 (2d ed. 2005).

Typically, although not always, builder's risk policies are written on an “all-risk” basis. In other words, a builder's risk policy will cover all causes of loss except those that are specifically excluded from coverage.³ Builder's risk policies, in theory, are supposed to cover fortuitous events caused by external forces. Builder's risk policies commonly exclude losses caused by: (i) war; (ii) dishonest acts of the insured; (iii) wear and tear, gradual deterioration, corrosion, rust, and rot; (iv) mold; (v) inherent vice and latent defect; (vi) insects and rodents; (vii) settling, cracking, shrinking, or expansion of walls, ceilings, floors, roofs, foundations, etc.; (viii) changes or extremes of temperature and humidity; (ix) damage by rain, snow, sleet, or ice; (x) fungus, wet or dry rot, and bacteria; (xi) asbestos removal; (xii) release of pollutants; (xiii) delay, loss of use, loss of market, fines, penalties, indirect losses, and other consequential losses, and faulty workmanship, inherent or latent de-

³ A named perils policy, in contrast, provides coverage only for specified perils. Even though most builders risk policies are written on an “all-risk” basis, the term “all-risk” does not equate with “all-loss.” Even when written on an “all-risk” basis, the scope of coverage is tailored by specific exclusions. While it is the insured's burden to establish a *prima facie* case of coverage, it is incumbent on the insurer to prove the application of any exclusions or affirmative defenses. *See* TEX. INS. CODE ANN. § 554.002.

fects, wear and tear, certain types of water damage, etc.; (xiv) enforcement of building ordinances or laws; (xv) flood, mudslide, sewer backup, and seepage of water; (xvi) earthquake, volcanic activity, and other earth movement; (xvii) mechanical breakdown, electrical injury, and boiler explosion; (xviii) testing; (xviii) design error and faulty workmanship or materials; (ix) collapse; and (xx) loss covered under guarantee, warranty, or obligation of manufacturer or supplier.⁴

Even so, because many of the exclusions are subject to “ensuing loss” or “resulting damage” exceptions, coverage oftentimes exists at least to some extent for physical damage that results from or ensues from an otherwise excluded event. In particular, in the construction defect context, it is fairly common for the faulty workmanship and design error exclusions to be subject to “resulting damage” or “ensuing loss” exceptions. Moreover, although the list of excluded perils is quite long, specific coverage can often be tailored by endorsement during the underwriting phase.

An important aspect of builder’s risk policies is that such policies typically only cover *new* construction as well as materials on the construction site that have yet to be incorporated. Thus, when a policy is issued to cover construction work on a structure that is already in existence, coverage under the builder’s risk policy usually will only cover the value of the *new* work and will not cover any damage to the *existing* structure.

Economic losses, in addition to physical losses, may also be experienced due to a casualty loss. For example, the delay in completing a construction project may result in extra expenses that would not have been incurred had there been no delay. Likewise, an income loss may occur when a delay in the completion of a construction project interferes with an anticipated revenue stream. These types of economic losses are known as “indirect losses” or “time element” losses. Absent endorsement, and much to the dismay of many insureds, these economic or indirect losses are typically excluded by a builder’s risk policy. Endorsements to cover “indirect losses” or “time element” losses, however, are readily available in the marketplace and typically insurers will negotiate specific terms depending on the need of the particular insured. Although a variety of names exist for such endorsements, they are most commonly referred to as “soft cost” or “delayed completion” endorsements.

C. Excess and Umbrella Policies

Liability coverage is usually arranged in “stacks” or “layers” of **primary insurance** and **excess insurance**. The primary coverage may, for example, have maximum limits of \$2 million, the next layer is \$10 million excess of the first \$2 million, the next is \$5 million excess of \$12 million, and so on. “*Primary* insurance is coverage that attaches immediately upon the happening of an occurrence that is covered under the terms of the policy.” BARRY R. OSTRAGER & THOMAS R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES § 6.03[a] (14th ed. 2008) (citations omitted) (emphasis in original). In contrast, “[e]xcess or *secondary* insurance is coverage that attaches only after a predetermined amount of primary coverage has been exhausted.” *Id.* (emphasis in original). *See also Continental Marble & Granite v. Canal Ins. Co.*, 785 F.2d 1258, 1259 (5th Cir. 1986) (same). “Texas law dictates that primary policies’ limits must be exhausted before excess insurers become liable.” *St. Paul Mercury Ins. Co. v. Lexington Ins. Co.*, 78 F.3d 202, 209 (5th Cir. 1996). “[A] true excess policy is one which is specifically intended to only come into play when the limits of the underlying cov-

⁴ For a more in-depth discussion of the various exclusions, see W. Kyle Gooch, *Builders Risk: The Devil Is In the Exclusions*, Construction Law Conference (2003).

erage are exhausted. It is issued in anticipation of the existence of the underlying policy and is priced in the belief that the excess carrier will not have to provide a defense.” *Tex. Employers Ins. Ass’n v. Underwriting Members of Lloyds*, 836 F. Supp. 398, 407 (S.D. Tex. 1993) (quoting *Guar. Nat’l Ins. Co. v. Am. Motorists Ins. Co.*, 981 F.2d 1108, 1109 (9th Cir. 1992)). Thus, a significant difference between excess insurance policies and primary insurance policies is that primary insurance policies contain first dollar exposure.

In addition, the primary policy, as opposed to the excess policy, generally responds to defend the policyholder. Although the excess insurer usually need not provide or participate in the defense of the policyholder, there are exceptions, such as when the underlying layer of coverage has been exhausted and the excess policy contains a defense provision. When “following form,” the excess policy will follow the coverages afforded by the primary policy unless specifically noted in the excess policy.

Policyholders often purchase umbrella coverage as well. **Umbrella policies** generally provide broader coverage than the “underlying” insurance policies, and thus, at times, can provide a defense when the CGL policy does not provide coverage. One court explained the difference between umbrella policies and excess policies:

Umbrella policies differ from standard excess insurance policies in that they are designed to fill gaps in coverage both vertically (by providing excess coverage) and horizontally (by providing primary coverage). Moreover, this interpretation is consonant with the broader function served by umbrella policies—extending coverage even to unanticipated “gaps.”

Commercial Union Ins. Co. v. Walbrook Ins. Co., 7 F.3d 1047, 1053 (1st Cir. 1993) (internal citations omitted).

D. Errors and Omissions Policies

Errors and omissions policies provide limited coverage, sometimes as a supplement to a CGL policy, for conduct undertaken in performing or rendering professional acts or services. *See Bollinger Shipyards Lockport, L.L.C. v. Amclyde Engineered Prods., Inc.*, 2003 WL 21396773, *5 (E.D. La. 2003). *Id.* “An errors-and-omissions policy is professional-liability insurance providing a specialized and limited type of coverage as compared to comprehensive insurance; it is designed to insure members of a particular professional group from the liability arising out of a special risk such as negligence, omissions, mistakes and errors inherent in the practice of the professions.” *Venture Encoding Serv., Inc. v. Atl. Mut. Ins. Co.*, 107 S.W.3d 729, 736 (Tex. App.—Fort Worth 2003, no pet.) (citing *Snug Harbor, Ltd. v. Zurich Ins.*, 968 F.2d 538, 543 n.16 (5th Cir. 1992)).

CGL policies frequently exclude coverage for professional liability exposures (e.g., exposures generally applicable to engineers and architects)—especially when such exposures result in purely economic losses. For example, a design flaw that causes delay will not be covered under a CGL policy unless the delay resulted from “property damage.” In contrast, economic loss resulting from the errors and omissions of a professional may be covered under a professional liability or errors and omissions policy.

III. STRUCTURE OF THE CGL POLICY

Because the CGL policy is the most litigated in the context of construction defect claims, this section of the paper focuses on the CGL.

A. Declarations Page

The **declarations page**, or the “dec page,” provides basic information about the specific policy, including the identity of the insurance company that issued the policy; the identity of the named insured; the effective dates of the policy coverage; the type of coverage provided (e.g., errors and omissions or CGL coverage); the amount of coverage, including per occurrence and aggregate limits of liability; the amount of any self-insured retention or deductible; the identity of the insurance agent or broker; the amount of premium to be charged; and a schedule of forms and endorsements that make up the policy. Note that some policies are issued as “packages” and, therefore, may include several base policy forms (e.g., errors and omissions coverage *and* CGL coverage). In such case, ensure that all the base policy forms and declarations pages are included in the policy.

B. Insuring Agreement

The **insuring agreement**, or grant of coverage, describes the coverage afforded by the policy. CGL policies provide three basic types of coverages—liability coverage (Coverage A), personal and advertising injury coverage (Coverage B), and medical payments coverage (Coverage C). Here, our focus is on Coverage A of the standard CGL policy. Coverage A is comprised of two sections—the insuring agreement and exclusions. Under the insuring agreement of Coverage A, the insurer agrees to pay those sums that the insured becomes legally obligated to pay as damages because of “bodily injury” or “property damage” to which the insurance applies. In addition, the “bodily injury” or “property damage” must occur during the “policy period” and be caused by an “occurrence” that takes place in the coverage territory. Moreover, prior to the “policy period” no insured can have known that the “bodily injury” or “property damage” occurred. This portion of the insuring agreement is known as the “duty to indemnify” the insured.

The insuring agreement also contains an agreement to defend the insured in the event of a covered loss. Because it can be quite expensive to defend a policyholder in construction litigation (or any litigation, for that matter), the duty to defend oftentimes is even more valuable to a policyholder than the duty to indemnify. Under the standard form CGL policy, policy limits are applicable only to damages. This means that costs and expenses incurred in defending the insured against covered claims are payable in addition to the applicable limits of insurance. In contrast, some CGL policies (but more often errors and omissions policies) are “**wasting**” or “**eroding**” policies. A “wasting policy” is one in which the policy limits are reduced by the costs and attorneys’ fees incurred in defending an action. Stated differently, when a policy is a wasting policy, payment of legal expenses reduce the limits left to pay a settlement or judgment.

Protection under a CGL policy may be provided on either an “occurrence” or on a “claims-made” basis. An “**occurrence policy**,” which is the type of coverage most CGL policies afford, provides coverage for a covered claim arising from “bodily injury” or “property damage” that occurred during the policy period, regardless of whether the insured knows about the occurrence, or whether the third party makes a claim against the insured within the policy period. In contrast, a “**claims-**

made policy” provides coverage only for claims that actually are made, or come to the attention of the insured during the policy period. *Pilgrim Enters. Inc. v. Md. Cas. Co.*, 24 S.W.3d 488, 497 (Tex. App.—Houston [1st Dist.] 2000, no pet.); *Yancey v. Floyd West & Co.*, 755 S.W.2d 914, 918 (Tex. App.—Fort Worth 1988, writ denied).

C. Definitions

Definitions are important when interpreting policy coverage, and should always be given careful consideration. Terms that are defined in the policy usually are italicized, bolded, underlined or set off by quotation marks (or a combination of the foregoing). Words used in an insurance policy are given their “plain and ordinary meaning,” unless they are defined in the policy. *Canutillo I.S.D. v. Nat’l Union Fire Ins. Co.*, 99 F.3d 695, 700 (5th Cir. 1996). See also *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 242 S.W.3d 1, 8 (Tex. 2007) (noting that undefined terms are given their “generally accepted or commonly understood meaning”).

D. Exclusions

Exclusions eliminate coverage that would otherwise be provided under the insuring agreement. Exclusions will apply only to the insuring agreement(s) that they modify and are tied into one section by reference to its coverage part. When making coverage determinations under Texas law, policy exclusions are construed narrowly, with all doubts as to their application construed in favor of the insured. If there is an ambiguity in the policy provisions, particularly in exclusionary clauses, the policy will be construed strictly against the insurer and in favor of coverage. *Balandran v. Safeco Ins. Co. of Am.*, 972 S.W.2d 738, 741 (Tex. 1998). See also *Ramsay v. Md. Am. Gen. Ins. Co.*, 533 S.W.2d 344, 349 (Tex. 1976) (“It is a settled rule that policies of insurance will be interpreted and construed liberally in favor of the insured and strictly against the insurer, and especially so when dealing with exceptions and words of limitation.”).

E. Conditions

Policy **conditions** include certain obligations of the policyholder, and can eliminate coverage for an otherwise covered claim if not performed. Typical conditions for coverage to apply include payment of the policy premium, providing timely notice of claims, assisting and cooperating with the insurer in its investigation and defense of claims, and refraining from incurring obligations in connection with claims without the consent and permission of the carrier. Certain of the conditions are discussed in greater detail below.

F. Endorsements/Additional Insured Endorsements

Endorsements are policy forms that are attached to the standard CGL policy form, which may either broaden or restrict coverage. Again, all policy endorsements should be listed on the schedule of forms found on the “dec page,” but it always is a good idea to review the entire policy. In fact, in litigation involving insurance coverage, one should always obtain a certified copy of each policy potentially triggered by the claims as issue. With respect to each policy, ensure that the endorsements listed on the schedule are included and that the form number on the schedule matches the endorsements actually attached to the policy. The absence of an endorsement or the inclusion of an incorrect endorsement can alter the entire coverage analysis.

One important endorsement in the construction-litigation context is the **additional insured** endorsement. It is common practice in the construction industry for owners to require contractors to name them as additional insureds under their CGL policies, and for contractors, in turn, to require their subcontractors to do the same. *See* PHILLIP L. BRUNER & PATRICK J. O’CONNOR, 4 BRUNER & O’CONNOR ON CONSTRUCTION LAW § 11:56 (1st ed. 2002) (updated 2009). The obligation generally arises by way of a provision in the contract requiring one party to name the other as an additional insured under its liability policy. To comply with the contract provision, the policyholder then obtains an additional insured endorsement that grants coverage to the additional insured under certain circumstances. *Id.* The endorsement can be limited and specific or very broad and general and, thus, can appear in any number of forms. The review of the benefits and pitfalls of each additional insured endorsement is beyond the scope of this paper. Notably, the additional insured often does not receive a copy of the actual endorsement, but rather receives what is known as a “certificate of insurance,” which states that the additional insured has in fact been added to the policy. *Id.* The certificate of insurance, in and of itself, however, confers no rights onto the additional insured.

Indemnity or “hold harmless” agreements, in contrast, create an obligation on the part of the indemnitor to pay the cost of any loss or damage that an indemnitee has incurred while acting at the indemnitor’s request. The indemnity agreement establishes which party will bear losses suffered during the performance of the contract. Indemnity agreements are the most widely used non-insurance method for transferring the financial consequences of risk to another party. PATRICK J. WIELINSKI, ET AL., CONTRACTUAL RISK TRANSFER: STRATEGIES FOR CONTRACT INDEMNITY AND INSURANCE PROVISIONS § XI.B.1 (2003). For example, subcontractors typically agree to indemnify and hold harmless general contractors for liability arising out of construction operations. Under the typical indemnity agreement, the subcontractor would be required to pay the general contractor’s defense, judgments, and/or settlement costs should the contractor be held liable for injuries or damages caused by the subcontractor. The indemnity agreement does not confer additional insured status on the indemnitee. Stated differently, the indemnitee is not an insured under the indemnitor’s policy and has no direct rights under the policy. DONALD S. MALECKI, THE ADDITIONAL INSURED BOOK 2 (5th ed. 2004). While contractual assumptions of liability are excluded by a standard CGL policy, an exception exists for indemnity agreements where an insured assumes the *tort* liability of another. This is known as the “insured contract” exception to the “contractually assumed liability” exclusion.⁵

The numerous issues that arise in the context of additional insured endorsements and contractual indemnity agreements are beyond the scope of this paper. It is important to note, however, that in looking for coverage, owners and contractors should not overlook their additional insured status under policies purchased by other entities, or indemnification agreements in the construction contracts.

IV. LIMITS OF INSURANCE

The CGL insuring agreement specifies that “the amount [the insurer] will pay for damages is limited as described in Section III—Limits of Insurance,” and an insurer’s duty to defend its insured ends when the applicable limit of insurance in the payment of judgments or settlements has been ex-

⁵ It is important to note that construction contracts oftentimes refer to “contractual liability coverage.” The reference to contractual liability *coverage* is a misnomer as a CGL policy does not affirmatively cover contractual indemnity obligations. Rather, as stated above, a valid broad form indemnity whereby an insured assumes the tort liability of another constitutes an “insured contract” and thus falls within an exception to an exclusion. The indemnity itself must still fall within the insuring agreement and outside the scope of other exclusions in order to trigger coverage under the CGL policy.

hausted. Accordingly, the policy's limits of insurance affect both the extent to which the insured is indemnified against the legal obligation to pay damages and the extent to which the insured will be defended in a suit seeking covered damages. Policy limits of insurance are entered as dollar amounts on the declarations page of the policy for each coverage provided in the policy. A CGL policy contains six limits of insurance that may govern the amount payable on behalf of the insured for any given claim. The key limits are addressed below:

A. Each Occurrence Limit

This limit applies to all covered bodily injury and property damage incurred as the result of any one occurrence. Thus, regardless of the number of injuries or instances of "property damage" caused by a single occurrence, this is the most that the insurer will pay in total damages for that occurrence. Most often, the each occurrence limit is set at \$1 million in a primary policy (although it may be higher). Excess and umbrella policies generally have higher each occurrence limits.⁶

B. General Aggregate Limit

This limit applies to all covered "bodily injury" and "property damage" (except for injury or damage arising out of the "products-completed operations hazard"), and all covered "personal and advertising injury." When paid losses in these categories reach the specified aggregate limit, that limit is exhausted and no more losses in any of those categories will be paid under the policy. In other words, once the general aggregate limit is paid out, the only coverage remaining under the policy will be for products-completed operations claims—which are paid out of a separate aggregate. For "property damage" claims, the general aggregate limit applies to losses that occur during the course of construction. Normally, the CGL general aggregate limit is \$2 million (but could be higher). Like the each occurrence limit, the general aggregate limit generally is higher for excess and umbrella policies.

C. Products-Completed Operations Aggregate Limit

This aggregate limit applies to all covered "bodily injury" and "property damage" included in the "products-completed operations hazard." For "property damage" claims, the "products-completed operations hazard" applies to damages that occur after construction is complete. Such losses do not erode the general aggregate limit discussed above. Like the aforementioned limits, the products-completed operations aggregate limit is typically \$2 million (but could be higher). While the basic products-completed operations aggregate limit generally is the same as the general aggregate limit, it is not mandatory that the same amount be utilized for the two aggregate limits. In fact, it may be desirable to carry a higher aggregate for one of these coverages than the other depending on the insured's work.

⁶ Texas looks at the cause or causes of a particular claim to determine the number of occurrences. *Lennar Corp. v. Great Am. Ins. Co.*, 200 S.W.3d 651, 682 (Tex. App.—Houston [14th Dist.] 2006, pet. denied). This is known as the "cause" test. *See id.* As a practical matter, the "cause" test oftentimes focuses on the number of liability triggering events in determining the number of occurrences. *See H.E. Butt Grocery Co. v. Nat'l Union Fire Ins. Co.*, 150 F.3d 526, 530 (5th Cir.1998). Thus, for example, if a homebuilder is sued for installing defective stucco on numerous homes, it is likely that a court will conclude that each home constitutes a separate occurrence. *See Lennar Corp.*, 200 S.W.3d at 682-83.

V. INSURING AGREEMENT REQUIREMENTS

With respect to construction defect cases, the *Lamar Homes* decision stands at the forefront of Texas law on insurance coverage. The Supreme Court of Texas' decision finally answered what constitutes an "occurrence" and what qualifies as "property damage" in the construction context. See *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 242 S.W.3d 1 (Tex. 2007).

A. "Occurrence"

The standard CGL policy defines "occurrence" as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions." Insurers argued for years that an insured's faulty workmanship on a project could not constitute an "occurrence" because general contractors should expect that faulty workmanship will result in damage to the project itself. Thus, it could not be an "accident." In addition, insurers claimed that an insurance policy covers tort liability not liability for a breach of contract.

The Supreme Court of Texas, however, disagreed with those positions, finding that the policy makes no mention of a contract versus tort distinction. Particularly, the Court noted that "the CGL policy makes no distinction between tort and contract damages" and that the "insuring agreement does not mention torts, contracts, or economic losses; nor do these terms appear in the definitions of 'property damage' or 'occurrence.'" *Lamar Homes*, 242 S.W.3d at 13. The Court also rejected "foreseeability" as "the boundary between accidental and intentional conduct." *Id.* at 8. The Court realized that using foreseeability as the test effectively would render insurance illusory. Moreover, the Court properly concluded that Mid-Continent's "argument includes a false assumption that the failure to perform under a contract is always intentional (or stated differently 'that an accident can never exist apart from a tort claim')." *Id.* (internal citations omitted).

Thus, according to the Court, "a claim does not involve an accident or occurrence when either direct allegations purport that the insured intended the injury (which is presumed in cases of intentional tort) or circumstances confirm that the resulting damage was the natural and expected result of the insured's actions, that is, was highly probable whether the insured was negligent or not."⁷ *Id.* at 9 (citation omitted). Further, according to the Court, the term "occurrence" is not defined "in terms of the ownership or character of the property damaged by the act or event. Rather, the policy asks whether the injury was intended or fortuitous, that is, whether the injury was an accident." *Id.* In other words, an insured's conduct is an occurrence if it: (1) qualifies as an accident; and (2) results in harm that the insured did not expect or intend.

B. "Property Damage"

In the standard CGL policy, "property damage" is defined, in part, as "[p]hysical injury to tangible property, including all resulting loss of use of that property. . . . or [l]oss of use of tangible property that is not physically injured." Carriers argued that any damage to the construction project at issue constituted a purely economic loss that fell outside the definition of "property damage." Thus, for example, in *Lamar Homes*, Mid-Continent contended that the "cracks" in the stone veneer and

⁷ It seems likely that the "highly probable" language will be the subject of future litigation. In fact, at least one court already has broached the subject and determined that "highly probable" should be judged on an objective basis. See *Nat'l Union Fire Ins. Co. v. Puget Plastics Corp.*, 2010 WL 3362117 (S.D. Tex. Aug. 25, 2010).

sheetrock as well as the heaving foundation were nothing more than purely economic losses. Lamar Homes, on the other hand, argued that the definition of “property damage” simply required physical injury to tangible property or loss of use. The Court agreed. In particular, the Court recognized that the “definition does not eliminate the general contractor’s home” and that “allegations of cracking sheetrock and stone veneer are allegations of ‘physical injury’ to ‘tangible property’” so as to qualify as “property damage.” *Id.* While physical injury is not defined, the plain meaning connotes an alteration in appearance, shape, color, or in some other material dimension.

It is important to note that a construction *defect* alone does not qualify as “property damage” under a CGL policy. *See Building Specialties, Inc. v. Liberty Mutual Fire Ins. Co.*, 2010 WL 1990115 (S.D. Tex. May 17, 2010). Accordingly, the fact that a window is installed backwards or upside-down is a “defect” and would not qualify as covered “property damage.” If, however, the result of the inadequately installed window is that water is able to seep into the structure and damage sheetrock and framing, that resulting damage would qualify as “property damage.” *See, e.g., Lennar Corp. v. Great Am. Ins. Co.*, 200 S.W.3d 651 (Tex. App.—Houston [14th Dist.] 2006, pet. denied) (finding that Lennar Corp. was not entitled to recover the cost of replacing defective EIFS, but coverage did exist for water-damaged substrate, sheathing, framing, insulation, sheetrock, wallpaper, paint, carpet, carpet padding, wooden trim, and baseboards). Moreover, in a footnote, the court of appeals also held that damages caused during the repair of the covered water damage (e.g., broken windows, cracked driveways, and damaged landscape) also constituted “damages because of . . . property damage.” *Lennar Corp.*, 200 S.W.3d at 678 n.33. And, additionally, the court of appeals concluded that the costs of removing EIFS to access and repair the underlying water damage *or* to determine the areas of underlying water damage also would constitute “damages because of . . . property damage.” *Id.*

Texas law does not recognize purely economic damages as coming within the definition of “property damage” in standard liability insurance policies. *See Lamar Homes*, 242 S.W.3d at 12 (“faulty workmanship that merely diminishes the value of the home without causing physical injury or loss of use does not involve ‘property damage.’ ”); *Great American Lloyds Ins. Co. v. Mittlestadt*, 109 S.W.3d 784, 788 (Tex.App.2003) (diminished property value stemming from negligently constructing a home on encumbered property was an economic loss and not a “loss of use” and hence outside the definition of “property damage”); *Gibson & Assocs., Inc. v. Home Ins. Co.*, 966 F.Supp. 468, 474 (N.D.Tex.1997) (loss of business by shop owners due to street closing for upgrades on city property are economic losses and not “property damage”); *State Farm Lloyds v. Kessler*, 932 S.W.2d 732, 737 (Tex.App.1996) (pre-existing drainage and foundational problems in home that were misrepresented by the underlying defendants at the sale of home are economic and not property damage).

But, once “property damage” is established, the CGL policy covers consequential economic damages that flow from the “property damage.” *See National Union Fire Ins. Co. of Pittsburgh, Pa. v. Puget Plastics Corp.*, 532 F.3d 398, 403 (5th Cir. 2008); *Todd Shipyards Corp. v. Turbine Serv., Inc.*, 674 F.2d 401, 418, 423 (5th Cir.1982) (finding the insurer liable for consequential damages resulting from covered property damage when the policy provides coverage for liabilities that arise “because of” property damage); *see also Am. Home Assurance Co. v. Libbey-Owens-Ford Co.*, 786 F.2d 22, 26 (1st Cir.1986) (noting that the clause “because of property damage” in insurance coverage provisions allows recovery for consequential losses attributable to property damage). This follows from the fact that the insuring agreement of a standard CGL policy provides that the insurer “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.”

VI. EXCLUSIONS

The Supreme Court of Texas' decision in *Lamar Homes* settled a long-standing issue in Texas law regarding the "property damage" and "occurrence" requirements. Thus, after *Lamar Homes*, it became much more important to focus on the exclusions in determining coverage. With respect to the construction industry, the main exclusions oftentimes are referred to as the "business risk" exclusions. See, e.g., *Admiral Ins. Co. v. Little Big Inch Pipeline Co.*, 523 F. Supp. 2d 524 (W.D. Tex. 2007) (relying on *Lamar Homes* to conclude that the "property damage" and "occurrence" issues had been satisfied, but finding no coverage because of certain business risk exclusions). The following is a primer on several of the key exclusions that frequently arise in the construction defect context.

A. Exclusion B – The Contractual Assumption of Liability Exclusion

The "contractual assumption of liability" exclusion excludes coverage when an insured "assumes" the liability of another that would not otherwise exist in the absence of the contractual assumption. The exclusion has exceptions for certain contractual assumptions that fit within the definition of "insured contracts" (e.g., broad form indemnity agreements whereby an insured assumes the tort liability of another).

Exclusion B deals with "contractually assumed liability" and, at least traditionally, did not apply to breach of contract claims. The Fifth Circuit, in interpreting the scope of the exclusion, 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.

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 in the subcontract.

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. The Burlington Ins. Co.*, 147 F. Supp. 2d 523, 528 (N.D. Tex. 2000) (holding that the contractual liability exclusion does not apply even though the claimant sued the insured for breach of contract since 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 contractual 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 on other grounds*, 294 F. App'x 814 (5th Cir. Aug. 26, 2008); *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) (noting that the exclusion “precludes coverage when the insured contractually assumes liability for the conduct of a third party such as through an indemnity or hold harmless agreement.”).

Recently, however, the Supreme Court of Texas has indicated that the exclusion may apply on a broader basis. See *Gilbert Tex. Constr., L.P. v. Underwriters at Lloyd’s London*, 327 S.W.3d 118 (Tex. 2010). In *Gilbert*, the Supreme Court applied the exclusion to negate coverage when the only source of liability against the insured was based on contract. In other words, although the insured did not assume the liability of another, the Court ruled that the contractually assumed liability exclusion applied to negate coverage. The *Gilbert* decision stands in stark contrast to the other cases in Texas and elsewhere that had limited the application of the exclusion to situations when the insured assumes the liability of another. The impact of *Gilbert* is still undetermined. While it is clear that the Supreme Court does not view the exclusion in the same light as the Fifth Circuit, it is not clear whether the *Gilbert* decision is limited to its facts.

B. Exclusion J(5) – The “Performing Operations” Exclusion

Exclusion J(5) eliminates coverage for “[t]hat particular part of real property on which you or any contractors or subcontractors working directly or indirectly on your behalf are performing operations, if the ‘property damage’ arises out of those operations.” The exclusion only applies to damages to *real property* that occur *while* operations are being performed. See *Mid-Continent Cas. Co. v. JHP Dev., Inc.*, 557 F.3d 207 (5th Cir. 2009) (“The parties agree that the use of the present tense “are performing operations” in exclusion j(5) makes clear that the exclusion only applies to property damage that occurred during the performance of construction operations by JHP”); *Lamar Homes*, 242 S.W.3d at 11 (“This exclusion applies while operations are being performed.”); *Lennar Corp.*, 200 S.W.3d at 686 (“Giving the exclusion its plain meaning, the use of the present tense indicates the exclusion applies only to ‘property damage’ arising *while* Lennar is *currently* working on a project.”); *Luxury Living, Inc. v. Mid-Continent Cas. Co.*, 2003 WL 22116202, at *17 (S.D. Tex. 2003) (noting that exclusion J(5) could not apply because the underlying plaintiff claimed damage to the home after its closing); *CU Lloyd’s of Texas v. Main Street Homes*, 79 S.W.3d 687, 695 (Tex. App.—Austin 2002, no pet.) (“Since the underlying petitions indicate that Main Street had completed construction and sold the homes to the home buyers *before* the alleged damage resulted, the exclusion does not preclude Lloyd’s duty to defend Main Street.”).

By its own terms, any damage occurring after completion or occupancy would not fall within the scope of the exclusion. Likewise, damages to non-real property would fall outside of the exclusion. See, e.g., *Evanston Ins. Co. v. Adkins*, 2006 WL 2848054 (N.D. Tex. Oct. 4, 2004). Moreover, the purpose of the exclusion is to negate coverage only for “that particular part” of the real property on which work is being performed by or on behalf of the insured. Accordingly, the exclusion should not apply to damage to adjacent property or to property on which the insured was not working. See

Basic Energy Servs., Inc. v. Liberty Mut. Ins. Co., 2009 WL 2998134 (W.D. Tex. Sept. 18, 2009); *JHP Dev.*, 557 F.3d at 215 (discussing the identical language in exclusion J(6)); *Gore Design Completions, Ltd. v. Hartford Fire Ins. Co.*, 538 F.3d 365, 371 (5th Cir. 2008); *Scottsdale Ins. Co. v. Knox Park Constr., Inc.*, 2003 WL 22519536 (N.D. Tex. Nov. 6, 2003). Thus, despite the exclusion, coverage should exist for the repair, replacement, or restoration of otherwise non-defective work that is damaged as a result of defective construction. See *Basic Energy Servs.*, 2009 WL 2998134 at *10; *Gar-Tex Constr. Co. v. Employers Cas. Co.*, 771 S.W.2d 639, 643–44 (Tex. App.—Dallas 1989, writ denied); *Mid-United Contractors, Inc. v. Providence Lloyds Ins. Co.*, 754 S.W.2d 824, 828 (Tex. App.—Fort Worth 1988, writ denied); *Dorchester Dev. Corp. v. Safeco Ins. Co.*, 737 S.W.2d 380, 382 (Tex. App.—Dallas 1987, no writ).

C. Exclusion J(6) – The “Faulty Workmanship” Exclusion

Exclusion J(6), the “faulty workmanship” exclusion, excludes coverage for “[t]hat particular part of any property that must be restored, repaired or replaced because ‘your work’ was incorrectly performed on it.” Unlike exclusion J(5), the exclusion is not limited to “real property” and thus, in that sense, the exclusion is broader than exclusion J(5).

The term “your work” is defined in the CGL policy as “[w]ork or operations performed by you or on your behalf; and [m]aterials, parts or equipment furnished in connection with such work or operations.” The exclusion goes on to state, however, that it “does not apply to ‘property damage’ included in the ‘products- completed operations hazard.’” The policy defines the “products-completed operations hazard” to include all property damage arising out of the insured’s work—except “work that has not been completed or abandoned.” As a result, exclusion J(6) only applies to work that has not been completed or abandoned. See *Luxury Living*, 2003 WL 22116202, at *18 (“[T]he property damage to the Wards’ home is, by definition, part of the ‘products-completed operations hazard,’ as *Luxury* no longer owns or rents the Wards’ residence and the work done on the house has long been completed.”); *Main Street Homes*, 79 S.W.3d at 696–97 (holding that exclusion J(6) was inapplicable because the house had been completed and sold to the claimant prior to the claimed damage).

Even if the damages at issue occur during the course of construction, the exclusion does not apply if the defective work causes damage to otherwise non-defective work. See *JHP Dev.*, 557 F.3d at 215; *Gore Design*, 538 F.3d at 371; see also *Mid-Continent Casualty Co. v. Bay Rock Operating Co.*, 614 F.3d 105, 115 (5th Cir. 2010). Moreover, in order for the express language of the exclusion to apply, the damaged property must have had faulty work performed *on it*.

D. Exclusion L – The “Your Work” Exclusion

Exclusion L, in contrast to exclusions J(5) and J(6), applies to damages that fall within the “products-completed operations hazard.” Exclusion L negates coverage as follows:

Damage to Your Work

“Property damage” to “your work” arising out of it or any part of it and included in the “products- completed operations hazard.”

This exclusion does not apply if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor.

By its own terms, exclusion L eliminates coverage only for damage to the named insured's work that arises out of the named insured's work. See *Wilshire Ins. Co. v. RJT Constr., LLC*, 581 F.3d 222, 226 (5th Cir. 2009). In other words, it does not apply to: (i) damages to the named insured's work that arises out of work performed by subcontractors; or (ii) damages to a subcontractor's work that arises out of the named insured's work.

In *Lamar Homes*, the Supreme Court applied the exclusion as written. See *Lamar Homes*, 242 S.W.3d at 11–12. In particular, as recognized by the Supreme Court, the exception “was added to protect the insured from the consequences of a subcontractor's faulty workmanship causing ‘property damage.’” *Id.* at 11. This view is consistent with that held by several commentators in the field. *Id.* (citing 2 STEMPEL ON INSURANCE CONTRACTS § 14[13][D] at 14-224.8–14-224.9; 2 ALAN D. WINDT, INSURANCE CLAIMS & DISPUTES § 11.3 at 73–74 (4th ed. & 2006 Supp.)).

The Supreme Court explained that “[b]y incorporating the subcontractor exception into the ‘your-work’ exclusion, the insurance industry specifically contemplated coverage for property damage caused by a subcontractor's defective performance.” *Id.* at 12 (citations omitted). As recognized by the majority of the Court, the “subcontractor exception” does not create coverage; rather, it “reinstates coverage that would otherwise be excluded under the your-work exclusion.” *Id.* at 14.⁸

VII. CONDITIONS AND INSURED'S DUTIES UNDER THE CGL POLICY

Insurance policies have numerous “conditions” or “rules” that must be followed. Failure to follow the conditions can, in certain circumstances, lead to a forfeiture of coverage. The most common conditions involve notice, cooperation, and voluntary payments or settlement without consent. A prevalent issue for years has been whether an insurer must demonstrate prejudice in order to rely on a breach of these common conditions. At least with respect to notice provisions, the Supreme Court of Texas' recent jurisprudence appears to have cleared up this murky issue.

A. Notice

CGL policies generally require that the insured provide notice of a loss “as soon as practicable.” This condition is often coupled with a requirement that the insured must “immediately” forward any suit papers. Although the notice requirements are seemingly straightforward, they have generated a significant amount of case law.

Compliance with the provision that notice of an occurrence or accident be given “as soon as practicable” is a condition precedent, the breach of which voids policy coverage. *Broussard v. Lumbermens Mut. Cas. Co.*, 582 S.W.2d 261, 262 (Tex. Civ. App.—Beaumont 1979, no writ); see also *Milton v. Preferred Risk Ins. Co.*, 511 S.W.2d 83, 85 (Tex. Civ. App.—Houston [14th Dist.] 1974,

⁸ ISO has created an endorsement (CG 22 94) that eliminates the subcontractor exception language to exclusion L. See *Lamar Homes*, 242 S.W.3d at 14. Moreover, unlike exclusions J(5) and J(6), the CG 22 94 endorsement does not have a “that particular part” limitation. With CG 22 94 added to a CGL policy, no coverage exists for damage to the work itself—regardless of whether it was performed on the insured's behalf by a subcontractor. Accordingly, the presence (or lack thereof) of this endorsement will have a dramatic effect on the extent of coverage available for completed operations claims.

writ ref'd n.r.e.) (“All of the conditions precedent of an insurance policy must be strictly complied with before the insurer will be liable.”). “As soon as practicable” means as soon as notice would have been given by an ordinary prudent person in the exercise of ordinary care in the same or similar circumstances. *Atteberry v. Allstate Ins. Co.*, 461 S.W.2d 219, 221 (Tex. Civ. App.—El Paso 1970, writ ref'd n.r.e.) (citing *Allstate Ins. Co. v. Darter*, 361 S.W.2d 254, 255 (Tex. Civ. App.—Fort Worth 1962, no writ)). What constitutes a reasonable time within which notice must be given depends on the individual facts and circumstances of each particular case, including but not limited to age, experience, and capacity for understanding and knowledge that coverage exists. *Century Sur. & Ins. Corp. v. Anderson*, 446 S.W.2d 897, 901 (Tex. Civ. App.—Fort Worth 1969, no writ); *Nat'l Sur. Corp. v. Diggs*, 272 S.W.2d 604, 607 (Tex. Civ. App.—Fort Worth 1954, writ ref'd n.r.e.).

Under “occurrence” policies, the insured’s failure to notify the insurer does not absolve the insurer from paying the underlying judgment unless the lack of notice prejudices the insurer. *See PAJ, Inc. v. Hanover Ins. Co.*, 243 S.W.3d 630, 636–37 (Tex. 2008); *Coastal Refining & Marketing, Inc. v. U.S. Fid. & Guar. Co.*, 218 S.W.3d 279, 286–87 (Tex. App.—Houston [14th Dist.] 2007, pet. denied); *Harwell v. State Farm Mut. Auto. Ins. Co.*, 896 S.W.2d 170, 174 (Tex. 1995); *Liberty Mut. Ins. Co. v. Cruz*, 883 S.W.2d 164, 165 & n.3 (Tex. 1993). The purpose of the timely notice requirement is to enable an insurer to investigate the circumstances of an accident while the matter is fresh in the minds of the witness so that it may adequately prepare to adjust or defend any claims that may be asserted against persons covered by its policy. *Employers Cas. Co. v. Glens Falls Ins. Co.*, 484 S.W.2d 570, 575 (Tex. 1972). When an insurer must prove it was prejudiced by the insured’s failure to comply with the notice provisions, “the recognized purposes of the notice requirements form the boundaries of the insurer’s argument that it was prejudiced; a showing of prejudice generally requires a showing that one of the recognized purposes has been impaired.” LEE R. RUSS & THOMAS F. SEGAL-LA, 13 COUCH ON INSURANCE § 186:14 (3d ed. 2005) (updated 2009).

Under “claims-made” policies,⁹ on the other hand, the prejudice requirement only applies if notice is provided within the policy period. *See Prodigy Commc’ns Corp. v. Agric. Excess & Surplus Ins. Co.*, 288 S.W.3d 374 (Tex. 2009) (finding that notice requirement was not an essential part of the bargained-for exchange under the policy and, thus, failure to comply with the requirement—in the absence of prejudice—does not defeat coverage under a claims-made policy); *see also Fin. Indus. Corp. v. XL Specialty Ins. Co.*, 285 S.W.3d 877 (Tex. 2009) (finding that notice within a claims-made policy period is sufficient unless the insurer shows that it was prejudiced by any delay). Any notice given after a “claims-made” policy (and any applicable extended reporting period) ends will be insufficient as a matter of law. Accordingly, an insured must make sure it strictly follows the notice requirements of any “claims-made” policy even under this recent case law.

Whether an insurer is prejudiced by late notice is generally a question of fact. *See Coastal Refining & Marketing*, 218 S.W.3d at 287 (explaining that ; *Struna v. Concord Ins. Servs., Inc.*, 11 S.W.3d 355, 359-60 (Tex. App.—Houston [1st Dist.] 2000, no pet.). Moreover, the burden is on the insurer to prove prejudice and it is a difficult burden for an insurer to overcome. “Because of the inherently uncertain nature of its burden—demonstrating how events may have differed under a different set of facts—an insurer need not ‘show precisely what the outcome would have been had timely notice been given.’” *Trumble Steel Erectors, Inc. v. Moss*, 304 F. App’x 236 (5th Cir. Dec. 15, 2008)

⁹ Again, CGL policies typically are written on “occurrence-based” forms, but professional liability policies often are written on “claims-made” policies and, thus, this difference is important for construction matters.

(quoting *Am. Ins. Co. v. Fairchild Indus., Inc.*, 56 F.3d 435, 440 (2d Cir. 1995)). Even so, at least some courts will presume prejudice as a matter of law if the insured does not present an adequate excuse for the delinquent notice. See *Blanton v. Vesta Lloyds Ins. Co.*, 185 S.W.3d 607, 612-13 (Tex. App.—Dallas 2006, no pet.) (noting that insured had no excuse for delaying notice for two and one-half years). Late notice should be distinguished from no notice at all. If a judgment is entered against an insured without any notice being provided to the insurer, it is likely that a court will rule that prejudice exists as a matter of law. See *National Union Fire Insurance Co. of Pittsburgh, PA. v. Crocker*, 246 S.W.3d 603 (Tex. 2008); *Maryland Cas. Co. v. Am. Home Assurance Co.*, 277 S.W.3d 107 (Tex. App.—Houston [1st Dist.] 2009, pet. filed); *Trumble Steel*, 304 F. App'x at 239. See also *Windham v. Assurance Co. of Am.*, 2009 WL 2195898 (“With notice of the underlying lawsuit occurring only after a default judgment on liability had become final and non-appealable, Assurance is prejudiced as a matter of law because Assurance was unable to defend the liability claims against its Insured.”). Simply put, insureds should always err on the side of providing notice as early as possible.

In addition to timely providing notice of the claim, insureds are required to timely provide notice of suit and forward all suit papers. Under Texas law, an insurer does not have a duty to defend until the lawsuit is “tendered” to the insurer for a defense. See *E & L Chipping Co. v. Hanover Ins. Co.*, 962 S.W.2d 272, 278 (Tex. App.—Beaumont 1998, no writ); *Members Ins. Co. v. Branscum*, 803 S.W.2d 462, 466-67 (Tex. App.—Dallas 1991, no writ); see also *Travelers Indem. Co. v. Citgo Petroleum Corp.*, 166 F.3d 761, 768 (5th Cir. 1999). Compliance with the notice of suit provision is a condition precedent to the insurer’s liability on the policy. Moreover, CGL policies specifically prohibit voluntary payments, as discussed below. See *LaFarge Corp. v. Hartford Cas. Co.*, 61 F.3d 389, 399-400 (5th Cir. 1995). The general rule for notice is:

It is the service of citation upon the insured which imposes on the insured the duty to answer to prevent a default judgment. No duty is imposed on an insurer until its insured is served and sends the suit papers to the insurer. This action by the insured triggers the insurer’s obligation to tender a defense and answer the suit.

Branscum, 803 S.W.2d at 466-67. Stated otherwise, an insurer has no duty to defend *until* it has been put on notice. See *Travelers Indem. Co. v. Citgo Petroleum Corp.*, 166 F.3d 761 (5th Cir. 1999). Texas courts, consistent with this view, have not recognized a right to pre-tender defense costs even when the insurer cannot establish prejudice. See *L’Atrium on the Creek I, L.P. v. Nat’l Union Fire Ins. Co.*, 326 F. Supp. 2d 787, 792 (N.D. Tex. 2004); *Kirby Co. v. Hartford Cas. Ins. Co.*, 2004 WL 2165367 (N.D. Tex. Sept. 23, 2004); *Amica Mut. Ins. Co. v. St. Paul Fire & Marine Life Ins. Co.*, 2003 WL 21281666 (N.D. Tex. May 29, 2003). What is necessary to constitute “tender” depends on the terms of the policy. At the very least, however, an insured must provide the insurer with a copy of the latest amended pleading. See *Branscum*, 803 S.W.2d at 467. Moreover, the fact that an initial pleading does not trigger a duty to defend does not foreclose the possibility that an amended or supplemental pleading may do so. Accordingly, it is always important to tender amended and supplemental pleadings as soon as they are received.

B. Cooperation

CGL policies also require that the insured cooperate in the investigation, settlement, or defense of the claim or suit. Specifically, the cooperation clause typically states: “You and any other involved Insured must: . . . cooperate with us in the investigation, settlement or defense of the claim

or suit.” An insured has a duty to cooperate with its insurer in the defense of claims for which the insurer has a duty to defend. *Quorum Health Res., LLC v. Maverick County Hosp. Dist.*, 308 F.3d 451, 468 (5th Cir. 2002) (citing *State Farm Fire & Cas. Co. v. S.S.*, 858 S.W.2d 374, 385 (Tex. 1993)). On the other hand, if the insurer denies a duty to defend, the insured no longer has any duty to cooperate with the insurer. *See id.* at 468. *See also Lamar Baptist Church of Arlington, Inc. v. St. Paul Fire and Marine Ins. Co.*, 2009 WL 329885 (N.D. Tex. Feb. 10, 2009) (“The court concludes that the cooperation and assist feature is not applicable because St. Paul declined to assume, or participate in, Coronado's defense of the state court lawsuit, with the result that Coronado could not possibly cooperate and assist it in matters related to the lawsuit.”).

The cooperation clause serves to assist the insurance company to: (i) obtain information concerning a loss while the information is still fresh; (ii) determine its obligations to indemnify the loss and/or defend its insured; (iii) protect itself from fraudulent claims; and (iv) pursue a subrogation claim against a responsible third-party, if applicable. *See Rick Virnig, The Insured's Duty to Cooperate*, 6 J. OF TEX. INS. L. 11 (Fall 2005). To breach its duty to cooperate, an insured's conduct must materially prejudice the insurer's ability to defend the lawsuit on the insured's behalf. *See Coastal Refining & Marketing*, 218 S.W.3d at 298; *Martin v. Travelers Indem. Co.*, 450 F.2d 542, 553 (5th Cir. 1971). Assuming such a showing is made, however, the breach can relieve an insurer of any liability under the policy. *See State Farm Lloyds v. Brown*, 2009 WL 2902511 (N.D. Tex. Sept. 9, 2009) (citing *Filley v. Ohio Cas. Ins. Co.*, 805 S.W.2d 844, 847 (Tex. App.—Corpus Christi 1991, writ denied)); *see also Progressive County Mut. Ins. Co. v. Trevino*, 202 S.W.3d 811 (Tex. App.—San Antonio 2006, pet. denied) (holding that insured's total lack of cooperation constituted prejudice as a matter of law). The duty to cooperate, however, is limited to the insured's assistance in the liability lawsuit and does not extend to assisting the insurer in its coverage determination. *See Lafarge Corp. v. Hartford Cas. Ins. Co.*, 61 F.3d 389, 397 (5th Cir. 1995).

C. Voluntary Payments/Settlement Without Consent

The voluntary payments provision, also known as the settlement without consent clause generally states: “No insureds will, except at their own cost, voluntarily make a payment, assume any obligation, or incur any expense, other than for first aid, without our consent.” This condition also is oftentimes referred to as the voluntary assumption of liability condition. This condition is very important in the construction defect context because some contractors desire to “fix” the problem or damage and then notify their insurance company. Contractors that repair damage *before* putting their insurance carrier on notice run the risk of a coverage denial.

Some courts have held that an insurer must show prejudice in order to deny coverage based on breach of the settlement without consent condition. *See, e.g., Hernandez v. Gulf Group Lloyds*, 875 S.W.2d 691, 691 (Tex. 1994) (stating that insurer must demonstrate that insured prejudiced the insurer by settling claim without insurer's consent before coverage may be denied); *Ins. Co. of N. Am. v. McCarthy Bros. Co.*, 123 F. Supp. 2d 373, 379 (S.D. Tex. 2000) (“By demanding that an insurer prove prejudice, Texas law recognizes that only a material breach of a contract excuses performance.”); *Comsys Info. Tech. Servs., Inc. v. Twin City Fire Ins. Co.*, 130 S.W.3d 181, 191–92 (Tex. App.—Houston [14th Dist.] 2003, pet. denied) (“The mere fact that the insurer owes money that it does not wish to pay does not constitute prejudice as a matter of law.”); *Coastal Refining & Marketing*, 218 S.W.3d at 295 (finding that USF&G failed to provide evidence of prejudice and, therefore, rejecting USF&G's claim that Coastal violated the voluntary payments provision).

Notwithstanding the foregoing, the Fifth Circuit has stated that “[a]n insurer’s right to participate in the settlement process is an essential prerequisite to its obligation to pay a settlement.” *Motiva Enters., LLC v. St. Paul Fire & Marine Ins. Co.*, 445 F.3d 381, 386 (5th Cir. 2006). The court concluded that an insurer is prejudiced as a matter of law when “the insurer is not consulted about the settlement, the settlement is not tendered to it and the insurer has no opportunity to participate in or consent to the ultimate settlement decision” *Id.* Recently, a federal district court also held that an insured forfeited coverage by settling without consent. *See Hardesty Builders, Inc. v. Mid-Continent Cas. Co.*, 2010 WL 5146597 (S.D. Tex. Dec. 13, 2010). Until the Texas Supreme Court addresses the issue more clearly, the prejudice issue in the context of settlement without consent is likely to be resolved on a case-by-case basis. In any event, once the insurer has denied coverage, it cannot insist on the insured’s compliance with this provision. *See Enserch Corp. v. Shand Morahan & Co.*, 952 F.2d 1485, 1496 n.17 (5th Cir. 1992). Moreover, the Supreme Court has made it clear that once coverage is denied, the insurer also is unable to contest the reasonableness of the insured’s settlement. *See Evanston Ins. Co. v. ATOFINA Petrochemicals, Inc.*, 256 S.W.3d 660, 674 (Tex. 2008).

VIII. WHICH POLICY IS TRIGGERED?

Construction defect cases oftentimes involve latent damage or progressive damage that occurs over a period of time. This issue typically spawns fights among insurers and between insureds and insurers as to *when* the damage occurred and *which* policy or policies must respond. The reason for the fight is that most CGL policies are written on an “occurrence” basis. In occurrence-based policies, the insuring agreement specifically requires that the “property damage” must take place during the policy period. Contrast that with a claims-made policy wherein it is the *claim* that must be made and oftentimes reported during the policy period, even if the particular act or omission that caused the property damage happened prior to the policy period. Many professional liability policies issued to architects and engineers are written on a claims-made basis. The trigger analysis for claims-made policies is straightforward—the policy in place at the time a “claim” is first made is the one (and typically the only one) that is triggered provided that the claim is reported in a timely manner under the terms of the policy. The trigger analysis for occurrence-based policies, like the typical CGL policy, has, until recently, been less than straightforward.

Over the years, Texas courts have applied different “trigger” theories to determine whether a particular “occurrence” policy or whether numerous “occurrence” policies are triggered for a particular loss. While an in-depth analysis of the various trigger theories is beyond the scope of this paper, it is important to clarify certain misconceptions that surround the triggering of occurrence-based CGL policies.

Most notably, insureds oftentimes assume that the policy in place at the time of the alleged defective construction is the one that will be triggered. Typically, that is not the case. Rather, until recently addressed by the Supreme Court of Texas, the vast majority of cases that addressed the issue held that it was the policy in place at the time that the resulting damage became readily apparent that was triggered. *See Am. Home Assur. Co. v. Unitramp, Ltd.*, 146 F.3d 311, 313 (5th Cir. 1998); *Matthews Heating & Air Conditioning, LLC v. Liberty Mut. Fire Ins. Co.*, 384 F. Supp. 2d 988 (N.D. Tex. 2004); *Gehan Homes, Ltd. v. Employers Mut. Cas. Co.*, 146 S.W.3d 833, 845–46 (Tex. App.—Dallas 2004, pet. denied); *Cullen/Frost Bank of Dallas, N.A. v. Commonwealth Lloyd’s Ins. Co.*, 852 S.W.2d 252, 257 (Tex. App.—Dallas 1993, writ denied); *State Farm Mut. Auto. Ins. Co. v. Kelly*, 945 S.W.2d 905, 910 (Tex. App.—Austin 1997, writ denied) (“Texas courts have held that property loss occurs

when the injury or damage is manifested.”). Although it is always dangerous to place labels on trigger theories, this theory is commonly referred to as the “manifestation” trigger.

In a nutshell, the manifestation trigger provides that actual damage occurs when it becomes apparent or readily identifiable. Even so, damage does not automatically qualify as apparent or identifiable merely because it is “capable of being known by testing.” See *Unitramp*, 146 F.3d at 313. In particular, an insured is not required or duty bound to “conduct limitless tests and inspections for hidden defects.” *Id.* Instead, although it is a somewhat murky concept that is decided on a case-by-case basis, damage will be considered apparent and/or identifiable at the point when it is “capable of being perceived, recognized and understood.” *Id.* at 314. Adding to the confusion is the fact that courts have been careful to state that manifestation does not equate to discovery. See *Unitramp*, 146 F.3d at 314 (noting that “it is important to understand that ‘apparent’ does not mean ‘discovered’; just because something is unknown to an individual does not render it, in an objective sense, unapparent”).

Although the so-called manifestation trigger served as the majority rule in Texas for years, it was not the *only* trigger theory that has been applied in the context of a “property damage” case. At least three courts have applied a broader “exposure” trigger to determine which policy or policies are potentially triggered. See *Pine Oak Builders, Inc. v. Great Am. Lloyds Ins. Co.*, 2006 WL 1892669 (Tex. App.—Houston [14th Dist.] July 6, 2006, pet. granted), *aff’d in part and rev’d in part by* 279 S.W.3d 650 (Tex. 2009); *Pilgrim Enters., Inc. v. Md. Cas. Co.*, 24 S.W.3d 488 (Tex. App.—Houston [14th Dist.] 2000, no pet.); see also *Royal Indem. Group v. Travelers Indem. Co.*, 2005 WL 2176896 (N.D. Cal. Sept. 6, 2005) (applying Texas law). Under an exposure trigger, it is the policy or policies in place at the time of the exposure to the conditions that cause the property damage that is triggered. Courts applying a broader exposure trigger note that the CGL policy itself contains no “manifestation” requirement and that applying a manifestation trigger essentially converts an “occurrence” policy into a “claims-made” policy. See *Pine Oak Builders*, 2006 WL 1892669, at *7; *Pilgrim*, 24 S.W.3d at 496. Under the broader exposure trigger, allegations of continuous and repeated exposure to conditions (e.g., water intrusion) might implicate more than one policy. See *Pine Oak Builders*, 2006 WL 1892669, at *8.

Recently, however, the Supreme Court of Texas addressed the trigger issue head-on for the first time and, in doing so, adopting the “injury-in-fact” a/k/a/ the “actual injury” trigger. See *Don’s Building Supply, Inc. v. OneBeacon Ins. Co.*, 267 S.W.3d 20 (Tex. 2008). Under that theory, the 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 adopting that trigger theory on certified question from the Fifth Circuit Court of Appeals, the Supreme 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 24–25. Rejecting the manifestation trigger, the court said that the policy language “simply makes no provision for it.” *Id.* at 29. Moreover, “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,¹⁰ the Court also made clear that the poli-

¹⁰ The Court noted that the issue of trigger for “bodily injury” claims was not before it and, therefore, was not addressed. See *Don’s Building Supply*, 267 S.W.3d at 28 n.32. As a practical matter, the policy language itself—at least with respect to trigger—does not differentiate between “bodily injury” and “property damage” claims.

cy 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).

Although the Court has now ruled on the issue and selected a trigger theory, issues regarding its application likely will arise. For example, an issue remains as to how easy it will be to determine, retrospectively, when the moment of injury occurred. Nevertheless, as the Court made clear, “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.* at 29. Accordingly, this issue likely will rear its head as the courts attempt to apply this trigger theory in construction defect cases. *See, e.g., Amerisure Mutual Ins. Co. v. Travelers Lloyds Ins. Co.*, 2010 WL 1068087 (S.D. Tex. March 22, 2010); *Employers Mutual Cas. Co. v. Northern Ins. Co.*, 2010 WL 85023 (N.D. Tex. March 11, 2010).

In light of the foregoing, insureds still must be careful to place all *potentially* triggered policies on notice. As a rule of thumb, if the precise time of the damage is not known, it is oftentimes a good idea to put all carriers from the time of construction through the time of the claim on notice. As the facts materialize and the moment of injury (or injuries) is determined, the insurers can then be whittled down to the appropriate ones.

IX. THE DUTY TO DEFEND

The duty to defend may be the single most important aspect of a liability policy. At the very least, it is on equal footing with the duty to indemnify. The reasons are simple: we live in a litigious society and lawyers are expensive. In many cases, defense costs exceed (and sometimes far exceed) the amount of a judgment or settlement. Many insureds, whether individuals or small corporations, simply cannot afford to retain counsel and/or lack the litigation sophistication to retain appropriate counsel to staff a particular lawsuit.

The duty to defend solves these problems by requiring the insurer to fund the defense and play an active role in the litigation process. Moreover, since an insurer has a duty to defend its insured even if the allegations against it are “groundless, false, or fraudulent,” the duty to defend helps prevent an insured from being bankrupted by frivolous lawsuits. Thus, in a sense, the duty to defend is litigation insurance.

The importance of the duty to defend and its role in litigation cannot be understated. As one commentator has noted, an insurer’s defense obligation can have an influence on every step of the litigation process, including pleading and filing, case strategy, the jury charge, and negotiation and settlement strategies. *See* Ellen S. Pryor, *The Stories We Tell: Intentional Harm and the Quest for Insurance Funding*, 75 Tex. L. Rev. 1721, 1725-38 (1997). This observation certainly rings true in the context of construction defect litigation.

A. Burden of Proof

The burden of proof for the duty to defend is the same as for the duty to indemnify. The burden is on the insured to show that a claim against it is potentially within the scope of coverage under the policy. *See Federated Mut. Ins. Co. v. Grapevine Excavation Inc.*, 197 F.3d 720, 723 (5th Cir. 1999). If, however, the insurer relies on policy exclusions or other affirmative defenses to defeat the duty to defend, the burden shifts to the insurer to prove that one or more of the exclusions defeat the duty to

defend. *See Guar. Nat'l Ins. Co. v. Vic Mfg. Co.*, 143 F.3d 192, 193 (5th Cir. 1998); *see also* TEX. INS. CODE ANN. § 554.002 (previously 21.58(b)) (“The insurer has the burden of proof as to any avoidance or affirmative defense . . .”). Once the insurer proves that an exclusion applies, the burden then shifts back to the insured to show that the claim falls within an exception to the exclusion. *See Guaranty Nat'l*, 143 F.3d at 193; *Telepak v. United Servs. Auto. Ass'n*, 887 S.W.2d 506, 507–08 (Tex. App.—San Antonio 1994, writ denied).

B. Contours of the “Eight Corners” Rule

Texas courts apply the “**eight corners rule**” to determine whether an insurer has a duty to defend its insured. *See Zurich Am. Ins. Co. v. Nokia, Inc.*, 268 S.W.3d 487, 491 (Tex. 2008); *Nat'l Union Fire Ins. Co. v. Merchs. Fast Motor Lines, Inc.*, 939 S.W.2d 139, 141 (Tex. 1997); *Northfield Ins. Co. v. Loving Home Care, Inc.*, 363 F.3d 523, 528–35 (5th Cir. 2004). In undertaking the “eight corners” analysis, a court must compare the allegations in the live pleading to the insurance policy without regard to the truth, falsity, or veracity of the allegations. *See King v. Dallas Fire Ins. Co.*, 85 S.W.3d 185, 191 (Tex. 2002); *Northfield*, 363 F.3d at 528. Thus, at least in most circumstances, only two documents are relevant to the duty to defend analysis: (i) the insurance policy; and (ii) the pleadings of the third-party claimant. *See King*, 85 S.W.3d at 187. Facts ascertained before suit, developed in the process of litigation, or determined by the ultimate outcome of the suit do not affect the duty to defend. *See Trinity Universal Ins. Co. v. Cowan*, 945 S.W.2d 819, 829 (Tex. 1997); *Northfield*, 363 F.3d at 528.

Under the “eight corners rule,” the allegations in the pleadings are given a “liberal interpretation.” *See Merchs. Fast Motor Lines*, 939 S.W.2d at 141; *Guar. Nat'l Ins. Co. v. Azrock Indus.*, 211 F.3d 239, 243 (5th Cir. 2000). Any doubts must be resolved in favor of the insured. *See Merchs. Fast Motor Lines*, 939 S.W.2d at 141; *Harken Exploration Co. v. Sphere Drake Ins. PLC*, 261 F.3d 466, 474 (5th Cir. 2001). Moreover, even if the underlying plaintiff’s allegations do not clearly show there is coverage, the insurer, as a general rule, will be obligated to defend if there is, potentially, an action alleged within the coverage of the policy. *See Merchs. Fast Motor Lines*, 939 S.W.2d at 141; *Harken*, 261 F.3d at 471. Likewise, if the potential for coverage is found for any portion of a suit, the insurer must defend the entire suit. *See St. Paul Ins. Co. v. Tex. Dep't of Transp.*, 999 S.W.2d 881, 884 (Tex. App.—Austin 1999, pet. denied); *Northfield*, 363 F.3d at 528. Accordingly, alternative allegations of intentional and even malicious conduct will not defeat the duty to defend if combined with allegations that would otherwise trigger a potential for coverage. *See Harken*, 261 F.3d at 474; *Stumph v. Dallas Fire Ins. Co.*, 34 S.W.3d 722, 729 (Tex. App.—Austin 2000, no pet.).

It is uniformly accepted that the duty to defend is broader than the duty to indemnify. *See Burlington Ins. Co. v. Tex. Krishnas, Inc.*, 143 S.W.3d 226, 229 (Tex. App.—Eastland 2004, no pet.); *E&L Chipping Co. v. Hanover Ins. Co.*, 962 S.W.2d 272, 274 (Tex. App.—Beaumont 1998, no writ); *Northfield*, 363 F.3d at 528. Accordingly, an insurer may have a duty to defend even when the adjudicated facts ultimately result in a finding that the insurer has no duty to indemnify. *See Utica Nat'l Ins. Co. v. Am. Indem. Co.*, 141 S.W.3d 198, 203 (Tex. 2004); *Farmers Tex. County Mut. Ins. Co. v. Griffin*, 955 S.W.2d 81, 82 (Tex. 1997). In other words, it is well-settled that the duty to defend and the duty to indemnify are distinct and separate duties. *See Griffin*, 955 S.W.2d at 82; *Cowan*, 945 S.W.2d at 821–22. In contrast to the duty to defend, the duty to indemnify is not based on the third-party claimant’s allegations, but rather upon the actual facts that comprise the third party’s claim. *See Am. Alliance Ins. Co. v. Frito-Lay, Inc.*, 788 S.W.2d 152, 154 (Tex. App.—Dallas 1990, writ dism'd);

Canutillo I.S.D. v. Nat'l Union Fire Ins. Co., 99 F.3d 695, 701 (5th Cir. 1996). In fact, “[a]n insurer is not obligated to pay a liability claim until [the] insured has been adjudicated to be legally responsible.” *S. County Mut. Ins. Co. v. Ochoa*, 19 S.W.3d 452, 460 (Tex. App.—Corpus Christi 2000, no pet.). For this reason, the duty to indemnify is not ripe for determination prior to the resolution of the underlying construction defect claim *unless* the court first determines, based on the eight corners rule, that there is no duty to defend and the same reasons that negate the duty to defend also negate any potential for indemnity. *See Griffin*, 955 S.W.2d at 82. Unfortunately, sometimes this is stated as an absolute rule by the courts, holding that if there is no duty to defend there can be no duty to indemnify. *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 Carolina Cas. Ins. Co. v. Sowell*, 603 F. Supp. 2d 914, 935 (N.D. Tex. 2009) (“In the instant case, the court has determined that there are no claims asserted in the Underlying Lawsuits that fall outside an exclusion. It therefore follows that Carolina can have no duty to indemnify.”); *Century Sur. Co. v. Hardscape Constr. Specialties*, 2006 WL 1948063, *4 (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). The Supreme Court of Texas has an opportunity to address this issue in *D.R. Horton–Texas, Ltd. v. Markel International Insurance Co., Ltd.*, 2006 WL 3040756 (Tex. App.—Houston [14th Dist.] Oct. 26, 2006, pet. granted). In *D.R. Horton*, evidence not mentioned in the pleadings existed that makes clear that a duty to indemnify would exist under the actual facts even though a duty to defend was not triggered under the “eight corners” rule. *Id.* at *5 (acknowledging the existence of a “significant amount” of summary judgment evidence supporting a duty to indemnify)

In summary, the case law (both state and federal) reveals the following important contours of the duty to defend:

- An insurer is required to defend its policyholder if the allegations state a *potential* claim for coverage under the policy.
- The truth or veracity of the allegations are irrelevant—all factual allegations must be taken as true.
- The allegations should be interpreted liberally. Nevertheless, insurers are not required to read facts into the pleadings and/or imagine factual scenarios that might trigger coverage.
- When a petition alleges multiple or alternative causes of action, the insurer must examine each separate allegation to determine whether it has a duty to defend. If one alternative cause of action or allegation is within the terms of the policy, the insurer has a duty to defend the entire suit, including uncovered claims.
- The proper focus is on the factual allegations that establish the origin of the damages alleged in the petition rather than on the legal theories asserted in the petition.
- Any doubts concerning coverage are to be resolved in favor of the policyholder.

In short, an insurer has a duty to defend a lawsuit against its policyholder *unless* it can establish that a comparison of the policy with the complaint or petition shows on its face that there is no potential for coverage. Stated differently, an insurer can refuse to provide a defense only when the facts as alleged fall outside of the coverage grant or when they fall squarely within policy exclusions. As put simply by the Fifth Circuit: “When in doubt, defend.” *Essex Ins. Co. v. Hines*, 358 F. App’x 596, 597 (5th Cir. 2010). The fact that an initial pleading does not trigger a duty to defend, however, does not foreclose the possibility that an amended pleading may do so. Therefore, even if the carrier initially denies a duty to defend, it is important to tender all amended pleadings to the carrier with a renewed request for a defense.

C. The Extrinsic Evidence Debate

The role of extrinsic evidence in the duty to defend analysis continues to be an area of confusion and debate. As a general rule, the use of extrinsic evidence to either create or defeat a duty to defend violates a strict “eight corners” rule. Most jurisdictions, however, recognize an exception to the “eight corners” rule when the insurer knows or reasonably should know facts that would establish coverage. *See* ROBERT H. JERRY, II, UNDERSTANDING INSURANCE LAW § 111[c][2] (2d ed. 1996). A leading insurance treatise concurs with this approach:

The existence of the duty to defend is normally determined by an analysis of the pleadings. Extrinsic evidence can, however, serve to create a duty to defend when such a duty would not exist based solely on the allegations in the complaint.

* * *

An insurer should not be able to escape its defense obligation by ignoring the true facts and relying on either erroneous allegations in the complaint or the absence of certain material allegations in the complaint. The insurer’s sole concern should be with whether the judgment that may ultimately be entered against the insured might, either in whole or in part, be encompassed by the policy. There is authority to the contrary, holding that the insurer’s defense obligation should be determined solely from the complaint, but such authority is unreasoned and consists merely of a blind adherence to the general rule in a situation in which the general rule was never intended to apply.

1 ALLAN D. WINDT, INSURANCE CLAIMS & DISPUTES, REPRESENTATION OF INSURANCE COMPANIES AND INSURED § 4:3 (5th ed. 2007); *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).

California, for example, permits both the insured and the insurer to use extrinsic evidence in determining the duty to defend. Texas courts, to put it kindly, have been sporadic in their application of the “eight corners” rule. In June 2006, the Supreme Court of Texas weighed in on the debate. *See GuideOne Elite Ins. Co. v. Fielder Rd. Baptist Church*, 197 S.W.3d 305 (Tex. 2006). Unfortunately, the opinion provided as many questions as it did answers. The Court agreed with the lower court and *declined* to adopt an exception to the “eight corners” rule. Nevertheless, the court was careful to limit its decision to situations when the extrinsic evidence is “overlapping” evidence “relevant both to coverage and the merits . . .” *Id.* at 309. In other words, the court’s holding arguably is limited to situations when the extrinsic evidence is relevant to both the coverage case and the underlying case. By

implication, it seems that the court also would decline to adopt any exception to the “eight corners” rule that deals only with liability facts.

The issue becomes more difficult when the extrinsic evidence relates solely to “coverage” facts. 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 underpinnings of the duty to defend. In other words, insurers still will have to defend “groundless, false, or fraudulent” claims that otherwise state a potential for coverage. Under a “coverage only” exception, insurers will only 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). The Court in *GuideOne*, however, did not say one way or the other whether it would recognize the exception. On the one hand, the court did note: “Resort to evidence outside the four corners . . . is generally prohibited.” *Id.* at 307 (emphasis added). On the other hand, the court cited to other courts that had recognized a limited exception to the eight corners rule for “pure coverage questions” without disapproving of those cases. *Id.* at 308 n.2.

Since *GuideOne*, no state appellate court in Texas has recognized an exception to the “eight corners” rule. *See, e.g., 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). Nevertheless, the Fifth Circuit Court of Appeals continues to issue inconsistent opinions 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*, 579 F.3d 469 (5th Cir. 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*, 579 F.3d at 476. 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.* Accordingly, 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). Simply put, the extrinsic evidence debate appears that it will continue until the Texas Supreme Court settles the issue once and for all.

D. An Insurer’s Options When Faced With a Tender

When considering whether to defend or refuse to defend a tendered claim, an insurer has four options: (i) assume the policyholder’s **unqualified defense**; (ii) offer a **qualified defense** under a **reservation of rights** or **non-waiver agreement**; (iii) completely decline to assume the policyhold-

er's defense; or (iv) seek a **declaratory judgment** to adjudicate the insurer's obligations under the policy. *See Katerndahl v. State Farm Fire & Cas. Co.*, 961 S.W.2d 518, 521 (Tex. App.—San Antonio 1997, no writ).

1. Provide an Unqualified Defense

An insurer always has the option of offering an unqualified defense. Offering to defend unqualifiedly means the carrier agrees that coverage exists under the policy and that it is not reserving any right to later deny a defense or indemnity obligation under the policy. By doing so, the insurer can demand compliance with all policy conditions and may also assert the right of exclusive control of the defense. This is so because the insurer, by offering an unqualified defense, has waived any potential coverage defenses. *See State Farm Lloyds, Inc. v. Williams*, 791 S.W.2d 542, 552 (Tex. App.—Dallas 1990, no writ). Stated differently, there is no conflict of interest precluding the insurer's control over the defense since any and all liability assessed against the policyholder (within policy limits) will ultimately be borne by the insurer. Insurers rarely offer an unqualified defense in construction defect cases.

2. Provide a Qualified Defense

When faced with a lawsuit that raises good faith coverage questions, a prudent insurer will offer a qualified defense subject to either a reservation of rights or a non-waiver agreement. Under such circumstances, an insurer's offer to defend its policyholder subject to a reservation of its rights is not a breach of the insurer's duty to defend. *See Rhodes v. Chicago Ins. Co.*, 719 F.2d 116, 120 (5th Cir. 1983). An insurer may undertake an insured's defense and later deny coverage by reserving its rights, so long as the insured is advised that the insurer may use a policy defense to later void its duty to defend. *Am. Eagle Ins. Co. v. Nettleton*, 932 S.W.2d 169, 174 (Tex. App.—El Paso 1996, writ denied). The purpose of a reservation of rights and/or a non-waiver agreement is to permit the insurer to comply with its contractual obligation to defend while preserving its right to later contest coverage. *See Katerndahl*, 961 S.W.2d at 521.

Specifically, a reservation of rights is a unilateral action whereby the insurer informs the policyholder in writing of the specific coverage issues. More precisely, a reservation of rights letter informs the policyholder: (i) of the coverage defenses that the insurer *may* rely on to deny coverage; and (ii) that its defense of the policyholder does not waive these potential coverage defenses and/or estop the insurer from later raising them. A non-waiver agreement differs from a reservation of rights in that it is a bilateral arrangement whereby the policyholder contractually stipulates that the insurer's conduct following its receipt of notice will not waive policy defenses. Because a reservation of rights letter is unilateral, it is far more commonly used than a non-waiver agreement. Reservation of rights letters are very common in construction defect litigation and oftentimes are lengthy as insurers frequently cite to specific policy language that may apply to a particular claim.

Offering a qualified defense is a proper course of action *only* when the insurer has a good faith belief that the petition alleges conduct that may not be covered by the policy. *See Providence Wash. Ins. Co. v. A&A Coating, Inc.*, 30 S.W.3d 554, 556 (Tex. App.—Texarkana 2000, pet. denied); *Nettleton*, 932 S.W.2d at 174; *Rhodes*, 719 F.2d at 120. Absent a good faith belief, an offer of a qualified defense arguably constitutes a breach of the duty to defend. When, however, an insurer has a good faith belief that the allegations raise coverage issues, it will not breach its duty to defend by offering a

qualified defense. *See Nettleton*, 932 S.W.2d at 174. Moreover, if the insurer properly provides a qualified defense, it can insist on compliance with policy conditions. *See id.*; *see also State Farm Lloyds Ins. Co. v. Maldonado*, 963 S.W.2d 38, 40–41 (Tex. 1998); *First Gen. Realty Corp. v. Md. Cas. Co.*, 981 S.W.2d 495 (Tex. App.—Austin 1998, no pet.); *Motiva Enters. v. St. Paul Fire & Marine Ins. Co.*, 445 F.3d 381, 383 (5th Cir. 2006).

3. Outright Denial

An insurer can simply respond to a tender with an outright denial. Insurers should reserve outright denials for those situations when the insurer is certain of its “no coverage” position. Wrongfully refusing to provide a defense comes with consequences: (i) the insurer loses the right to select counsel and control the defense; (ii) the insurer loses any right to insist that the policyholder comply with policy conditions (e.g., “no action” clause; “no voluntary assumption of liability” clause); (iii) the insurer will be bound by the amount of a judgment entered against the insured; and (iv) the insurer will be liable for foreseeable damages flowing from the insurer’s breach of the duty to defend. *See Willcox v. Am. Home Assur. Co.*, 900 F. Supp. 850, 855 (S.D. Tex. 1995); *Whatley v. City of Dallas*, 758 S.W.2d 301 (Tex. App.—Dallas 1988, writ denied). In addition, an insurer that breaches its duty to defend is subject to penalty interest at the rate of 18% per annum for any damages, including defense costs and expenses, incurred by the insured. *See Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 242 S.W.3d 1, 19 (Tex. 2007). And, as noted earlier, an insurer cannot contest the reasonableness of any settlement entered into by the insured. *See Evanston Ins. Co. v. ATOFINA Petrochemicals, Inc.*, 256 S.W.3d 660, 674 (Tex. 2008). Even so, the insurer remains free to contest coverage for a judgment or settlement even when the denial of the duty to defend was improper.

4. Seek a Declaratory Judgment

A declaratory judgment is a judicial determination of the rights of respective parties. The purpose of declaratory judgments is to settle and afford relief from uncertainty and insecurity with respect to rights, status, and other legal relations. Declaratory judgments can be brought in federal court pursuant to 28 U.S.C. § 2201 or in state court under Chapter 37 of the Civil Practice and Remedies Code. Declaratory judgments play a big role in insurance disputes in that insurers frequently initiate declaratory judgments to resolve duty to defend disputes. Because the duty to defend is a question of law, declaratory judgments are typically disposed of by summary judgment.

The option to seek a declaratory judgment can be exercised in tandem with either an outright denial or an offer of a qualified defense. In fact, because of the negative consequences flowing from a breach of the duty to defend, prudent insurers will typically offer a qualified defense in cases when coverage is uncertain and then seek a declaratory judgment to determine if it has any obligations under the policy. By doing so, the insurer protects itself while still fulfilling its contractual obligations. On the other hand, the insured then finds itself involved in two lawsuits simultaneously—the underlying liability lawsuit arising from the claim under the policy, and the declaratory judgment lawsuit over coverage for the underlying claim.

E. A Policyholder’s Options When Offered a Qualified Defense

Generally speaking, a policyholder can respond to a reservation of rights letter in three ways: (i) ignore it; (ii) accept it; or (iii) reject it. An additional approach is to seek clarification by posing

questions to the insurer regarding the scope of its reservations. Ultimately, however, this approach will require the policyholder to either accept the reservations or reject them.

1. Ignore It: Silence May Equal Acquiescence

If a policyholder simply ignores a reservation of rights letter by taking no action to reject it, the policyholder runs a risk that a court may equate the policyholder's silence with acquiescence. *See W. Cas. & Sur. Co. v. Newell Mfg. Co.*, 566 S.W.2d 74, 76 (Tex. Civ. App.—San Antonio 1978, writ ref'd n.r.e.). Stated differently, if an insured allows the insurer to defend the action after receiving notice of the insurer's offer to defend under a reservation of rights, the insured impliedly agrees that the insurer will not thereby waive its right to later contest coverage. *Tex. Ass'n of Counties County Gov't Risk Mgmt. Pool v. Matagorda County*, 52 S.W.3d 128, 132–33 (Tex. 2000). Even so, regardless of whether the insured responds to a reservation of rights, the insurer may not unilaterally impose affirmative, extra-contractual obligations upon the insured by issuing a reservation of rights letter. *Id.*

If the policyholder is unsure about what to do, rather than taking no action in response to a reservation of rights letter, the best option is to pose questions to the insurer regarding the scope of its reservations. Nothing prevents a policyholder from expressing its opinion that the insurer should be offering an unqualified defense. As one commentator has noted, asking questions and seeking clarification puts the ball back into the insurer's court. *See Michael S. Quinn, Reserving Rights Rightly: The Romance and the Temptations*, COVERAGE, July–Aug. 1997, at 34. A well-drafted letter may persuade the insurer that an unqualified defense is warranted.

2. Accept It

If the policyholder accepts the reservation of rights, the insurer will typically select counsel and proceed with the defense of the case. If the policyholder has already retained counsel and wishes to continue with its retained counsel, the policyholder and the insurer should try to reach an equitable resolution to this issue. Usually, the issue boils down to whether the retained counsel will agree to a fee structure and billing guidelines. At this point, Texas law is far from clear as to whether the insurer can force the selection of new counsel. Generally, the answer may hinge on how far the case has progressed. If the litigation is in its infancy, an insurer can probably exercise its right to select counsel. If, however, the litigation has progressed, a strong argument can be made that any substitution of counsel would result in prejudice to the policyholder. Also, as will be discussed later, the issue will depend on the substance of the reservation of rights.

Although it has been mentioned above, it is important to reiterate that a policyholder who is being defended under reservation of rights is bound to abide by the policy's conditions. Thus, the policyholder must abide by the "no action" clause, the "settlement without consent" clause, and the "cooperation" clause. A violation of any of these may result in forfeiture of coverage. *See Ideal Mutual Ins. Co. v. Meyers*, 789 F.2d 1196 (5th Cir. 1986) (holding that the insurer can rely on the "no action" clause); *Maldonado*, 963 S.W.2d at 40–41 (finding that a policyholder may not take part in or allow a collusive "trial"); *see also Motiva*, 445 F.3d at 384–85 (holding that policyholder forfeited coverage by not including the insurer in the settlement discussions).

3. Reject It

Under certain circumstances, an insured is under no obligation to accept a qualified defense. See *Rhodes*, 719 F.2d at 120–21; *Britt v. Cambridge Mut. Fire Ins. Co.*, 717 S.W.2d 476, 481 (Tex. App.—San Antonio 1986, writ ref’d n.r.e.); *Ranger Ins. Co. v. Robertson*, 707 S.W.2d 135, 143 (Tex. App.—Austin 1986, writ ref’d n.r.e.). As succinctly stated by one court: “The law does not require an insured to accept a defense under reservation of rights agreement or non-waiver agreement.” *Ranger*, 707 S.W.2d at 143. This is especially so in conflict-of-interest scenarios. “Where the insurer is denying coverage, but at the same time demanding the right to defend the lawsuit on behalf of the insured, and where coverage, *vel non*, will depend upon the finding of the trier of facts as to certain issues in the main case, . . . the insurer is not in a position to defend the insured.” *Steel Erection Co. v. Travelers Indem. Co.*, 392 S.W.2d 713, 716 (Tex. Civ. App.—San Antonio 1965, writ ref’d n.r.e.). Although a policyholder may reject a qualified defense, that fact—in and of itself—does not give the policyholder free reign to settle the lawsuit. See *Motiva*, 445 F.3d at 383 (“[W]hen . . . the insurer is not consulted about the settlement, the settlement is not tendered to it and the insurer has no opportunity to participate in or consent to the ultimate settlement decision, we conclude that the insurer is prejudiced as a matter of law”).

A policyholder should consider rejecting a qualified defense when a conflict of interests exists *and* when the policyholder feels confident in its coverage position. In theory, there is little downside in rejecting a qualified defense in that circumstance because the insurer is still obligated to pay reasonable and necessary defense costs. See *Rhodes*, 719 F.2d at 120; *Britt*, 717 S.W.2d at 481. The only difference is that, after rejection of a qualified defense, the policyholder may have to front these costs and then seek reimbursement from the insurer. Of course, the policyholder also runs the risk that the insurer will respond to the policyholder’s rejection by completely denying coverage, and/or filing a declaratory judgment action.

F. The Right to Independent Counsel

Once an insured gets past the duty to defend hurdle, another important issue centers on the selection of counsel and, in particular, the right to independent counsel. More specifically, issues often-times arise as to whether the insurer or the insured gets to select counsel, who has to pay for independent counsel, and the appropriate rate to be paid by the insurer to independent counsel. A review of the so-called “tripartite” relationship between the insurer, the defense counsel, and the insured will help set the stage for the independent counsel debate.

G. The Tripartite Relationship

When an insurer assumes its insured’s defense, generally the insurer has the right to select defense counsel. Moreover, if no conflict of interest exists, the insurer may have exclusive control over the defense. When a conflict of interest exists (e.g., when the outcome of a coverage issue can be affected by the manner in which the underlying action is defended), however, one must be cognizant of the relationship among the liability insurer, its insured, and the defense counsel selected by the liability insurer to defend the insured. The relationship among these parties is known as the “tripartite relationship.”

A debate exists as to whether Texas is a “one client” or “two client” state. Essentially, the debate focuses on whether the insurer *also* is the client of defense counsel hired by the insurer to

represent the insured. See Charles Silver, *The Professional Responsibilities of Insurance Defense Lawyers*, 45 Duke L.J. 255 (1995); Charles Silver & Michael Quinn, *Wrong Turns on the Three-Way Street: Dispelling Nonsense About Insurance Defense Lawyers*, Coverage (Nov.–Dec. 1995). Texas law is far from clear on this point. But see *Unauthorized Practice of Law Committee v. Am. Home Assurance Co., Inc.*, 261 S.W.3d 24 (Tex. 2008) (suggesting Texas is a two-client state, at least when the interests of the insured and the insurer are aligned). Regardless, Texas law is clear that defense counsel owes “unqualified loyalty” to the insured. See *State Farm Mut. Auto. Ins. Co. v. Traver*, 980 S.W.2d 625, 628 (Tex. 1998); *Employers Ins. Cas. Co. v. Tilley*, 496 S.W.2d 552, 558 (Tex. 1973). As the Supreme Court of Texas pointed out in *Traver*, “the lawyer must at all times protect the interests of the insured . . .” *Traver*, 980 S.W.2d at 628. Despite the fact that defense counsel undeniably owes unqualified loyalty to the insured, the fact remains that the “so-called tripartite relationship has been well documented as a source of unending ethical, legal, and economic tension.” *Traver*, 980 S.W.2d at 633 (Gonzalez, J., concurring and dissenting). As Justice Gonzalez further noted:

The duty to defend in a liability policy at times makes for an uneasy alliance. The insured wants the best defense possible. The insurance company, always looking at the bottom line, wants to provide a defense at the lowest possible cost. The lawyer the insurer retains to defend the insured is caught in the middle. There is a lot of wisdom in the old proverb: He who pays the piper calls the tune. The lawyer wants to provide a competent defense, yet knows who pays the bills and who is most likely to send new business.

Id.

The import of **Error! Bookmark not defined.***Traver* and *Tilley* in the duty to defend context is that an insurer should not use the same counsel to review coverage that it does to defend the insured. See *Employers Cas. Co. v. Mireles*, 520 S.W.2d 516 (Tex. Civ. App.—San Antonio 1975, writ ref’d n.r.e.) (holding that the employment of separate firms to defend the insured and to address coverage issues eliminates conflicts of interest). Accordingly, when an insurer offers a qualified defense under a reservation of rights and proceeds by hiring defense counsel, the defense counsel should remain “independent.” Likewise, when a qualified defense under a reservation of rights is provided, defense counsel should never communicate with the insurer with respect to “coverage” issues or provide information to the carrier that has any bearing on coverage. See *Rhodes v. Chicago Ins. Co.*, 719 F.2d 116 (5th Cir. 1983).

H. Who Gets to Select Counsel?

Whether an insurer has the right to control the defense, which involves the right to select counsel, is a matter of contract. See *N. County Mut. Ins. Co. v. Davalos*, 140 S.W.3d 685, 688 (Tex. 2004); see also *Traver*, 980 S.W.2d at 627. Most policies vest this right in insurers. In fact, it may be a violation of the cooperation clause to refuse to allow an insurer to select counsel and control the defense when the insurer agrees to provide an unqualified defense. See *Burney v. Odyssey Re (London) Limited*, 2005 WL 81722 (N.D. Tex. Jan. 14, 2005), *aff’d*, 169 F. App’x 828 (5th Cir. 2006). “Under certain circumstances, however, an insurer may not insist upon its contractual right to control the defense.” *Davalos*, 140 S.W.3d at 688. In particular, an insurer must relinquish this right when a “conflict of interest” exists. *Traver*, 980 S.W.2d at 627. Even so, according to the Supreme Court of Texas, not every disagreement about how the defense should be conducted rises to the level of a con-

flict of interest. *See Davalos*, 140 S.W.3d at 689 (holding that a disagreement as to the proper venue for the defense of a third-party claim did not amount to a conflict of interest).

A big issue is whether the issuance of a reservation of rights constitutes a per se conflict of interest. To date, most courts that have addressed the issue have concluded that a reservation of rights does in fact create a sufficient conflict of interest that would warrant an insurer to relinquish its contractual right to control the defense. *See Rhodes v. Chicago Ins. Co.*, 719 F.2d 116, 120 (5th Cir. 1983) (“When a reservation of rights is made, however, the insured may properly refuse the tender of defense and pursue his own defense” and the “insurer remains liable for attorneys’ fees incurred by the insured and may not insist on conducting the defense.”); *Arkwright-Boston Mfrs. Mut. Ins. Co. v. Aries Marine Corp.*, 932 F.2d 442, 445 (5th Cir. 1991) (“The insured, confronted by notice of the potential conflict [through a reservation of rights], may then choose to defend the suit personally.”); *Am. Eagle Ins. Co. v. Nettleton*, 932 S.W.2d 169, 174 (Tex. App.—El Paso 1996, writ denied) (“Upon receiving notice of the reservation of rights, the insured may properly refuse tender of defense and defend the suit personally.”); *see also Britt v. Cambridge Mut. Fire Ins. Co.*, 717 S.W.2d 476, 481 (Tex. App.—San Antonio 1986, writ ref’d n.r.e.); *Steel Erection Co. v. Travelers Indem. Co.*, 392 S.W.2d 713 (Tex. App.—San Antonio 1965, writ ref’d n.r.e.).

More recent case law, however, suggests that the substance of the reservation of rights has to be considered in determining whether a conflict of interest exists. One of the more recent opinions to address this issue was authored by Judge Lindsay from the Northern District. *See Hous. Auth. of City of Dallas v. Northland Ins. Co.*, 333 F. Supp. 2d 595 (N.D. Tex. 2004). *Northland Insurance Company* stands for the proposition that a reservation of rights creates a disqualifying conflict so long as the facts to be developed in the underlying lawsuit are the same facts upon which coverage depends. *See id.* at 601–02. And, Judge Rosenthal issued an opinion in *RX.Com, Inc. v. Hartford Fire Ins. Co.*, 426 F. Supp. 2d 546 (S.D. Tex. 2006), finding that “[a] conflict of interest does not arise unless the outcome of the coverage issue can be controlled by counsel retained by the insurer for the defense of the underlying claim.” *Id.* at 559. Nevertheless, a more recent opinion from the Supreme Court of Texas sheds some grey light on the issue. *See Unauthorized Practice of Law Committee*, 261 S.W.3d at 40 (seemingly brushing aside the importance of reservation-of-rights letters and saying that “[a] reservation-of-rights letter ordinarily does not, by itself, create a conflict between the insured and the insurer” because it only recognizes that a conflict might exist later”).

Even when the right to independent counsel is recognized, a big fight oftentimes ensues as to “how much” the insurer must pay independent counsel. In particular, if independent counsel normally charges \$250 per hour whereas the counsel selected by the insurer charges \$165 per hour, can the insurer insist on paying the lower rate? Very little guidance is provided by Texas courts on this issue. The most rationale answer is that the insurer should be forced to pay what is reasonable and customary for the type and sophistication of the particular case. Notably, defense counsel that receive a large volume of work from a particular insurer oftentimes discount their rates. Independent counsel, who may or may not ever have another case involving the insurer, should not be forced to accept the discounted rate.

Another fight centers on whether independent counsel must follow litigation/billing guidelines. Very little guidance is provided by Texas courts on this issue as well. A Texas Ethics Opinion, however, does provide some insight. *See Tex. Comm. on Prof’l Ethics*, Op. 533 (2000) (“It’s impermissible under the Texas Disciplinary Rules of Professional Conduct for a lawyer to agree with an

insurance company to restrictions which interfere with the lawyer's exercise of his or her independent professional judgment in rendering such legal services the insured/client."). Ethics Opinion 533 basically stands for the proposition that a defense lawyer can follow billing/litigation guidelines so long as such guidelines do not interfere with the defense counsel's professional judgment. *Id.* In addition, in *Traver*, the Texas Supreme Court recognized that "the lawyer must at all times protect the interests of the insured if those interests would be compromised by the insurer's instructions." *Traver*, 980 S.W.2d at 628. In other words, while a prohibition on block billing may be permissible, it likely would not be permissible for an insurer to restrict research, discovery, or other matters that fall within the professional judgment of defense counsel.

GLOSSARY

Additional Insured:

A person or company added to the named insured's policy via endorsement. It is common practice in the construction industry for owners to require contractors to name them as additional insureds under their CGL policies, and for contractors, in turn, to require their subcontractors to do the same.

Builder's Risk Policy:

Builder's risk is first-party insurance designed to cover property damage during the construction phase of a project.

CGL Policy:

Commercial general liability (CGL) policies are liability policies designed to protect the insured against third-party lawsuits. CGL policies respond to "property damage" and "bodily injury" claims asserted by third parties.

Claims-Made Policy:

A "claims-made policy" provides coverage only for claims that actually are made, or come to the attention of the insured during the policy period.

Conditions:

Policy conditions include certain obligations of the policyholder, and can eliminate coverage for an otherwise covered claim if not performed. Typical conditions for coverage to apply include payment of the policy premium, providing timely notice of claims, assisting and cooperating with the insurer in its investigation and defense of claims, and refraining from incurring obligations in connection with claims without the consent and permission of the carrier.

Declarations Page:

The policy declarations page, or the "dec page," provides basic information about the specific policy, including the identity of the insurance company that issued the policy; the identity of the named insured; the effective dates of the policy coverage; the type of coverage provided (e.g., errors and omissions or CGL coverage); the amount of coverage, including per occurrence and aggregate limits; the amount of any self-insured retention or deductible; the identity of the insurance agent or broker; the amount of premium to be charged; and a schedule of forms and endorsements that make up the policy.

Declaratory Judgment Action:

A declaratory judgment is a judicial determination of the rights of respective parties. The purpose of declaratory judgments is to settle and afford relief from uncertainty and insecurity with respect to rights, status, and other legal relations. Declaratory judgments can be brought in federal court pursuant to 28 U.S.C. § 2201 or in state court under Chapter 37 of the Civil Practice and Remedies Code.

“Eight Corners” Rule:

Texas courts apply the “eight corners” or “complaint allegation” rule to determine whether an insurer has a duty to defend its insured. In undertaking the “eight corners” analysis, the factual allegations contained within the four corners of the live pleading are compared to the coverage provided within the four corners of the insurance policy.

Endorsements:

Endorsement are policy forms that are attached to the standard policy form, which may either broaden or restrict coverage. All policy endorsements should be listed on the schedule of forms found on the declarations page.

Errors and Omissions Policies:

Errors and omissions policies provide limited coverage, sometimes as a supplement to a CGL policy, for conduct undertaken in performing or rendering professional acts or services. It is designed to insure professionals (i.e., architects or engineers) from the liability arising out of a special risk such as negligence, omissions, mistakes and errors inherent in the practice of the profession.

Excess Insurance:

Excess insurance is coverage that, under the terms of the policy, attaches only after a predetermined amount of primary coverage has been exhausted. Excess policies typically have larger limits than the primary policies that they sit above. “Follow form” excess policies follow the coverages afforded by the primary policy unless specifically noted in the excess policy.

Exclusions:

Policy exclusions eliminate coverage that would otherwise be provided under the insuring agreement.

First-Party Coverage:

First-party coverage protects the insured and the insured’s assets against loss or damage. A first-party claim is one in which an insured seeks recovery for the insured’s own loss. Examples of first-party coverage include property insurance (e.g., builders risk), health insurance, life insurance, disability insurance, and fire insurance.

Indemnity Agreements:

Indemnity or “hold harmless” agreements create an obligation on the part of the indemnitor to pay the cost of any loss or damage that an indemnitee has incurred while acting at the indemnitor’s request. The indemnity agreement establishes which party will bear losses suffered during the performance of the contract. Indemnity agreements are the most widely used non-insurance method for transferring the financial consequences of risk to another party.

Insuring Agreement:

The insuring agreement, or grant of coverage, describes the coverage afforded by the policy and sets out the agreement to indemnify and the agreement to defend the insured in the event of a covered loss.

Non-waiver Agreement:

A non-waiver agreement is a bilateral arrangement whereby the policyholder contractually stipulates that the insurer's conduct following its receipt of notice will not waive policy defenses.

Occurrence Policy:

An "occurrence policy," which is the type of coverage most CGL policies afford, provides coverage for a covered claim arising from events that occurred during the policy period, regardless of whether the insured knows about the occurrence, or whether the third party makes a claim against the insured within the policy period.

Primary Insurance:

Primary insurance is coverage that attaches immediately upon the happening of an occurrence that is covered under the terms of the policy. Primary policies usually provide the primary defense obligation.

Qualified Defense:

A qualified defense is a defense offered by the insurer subject to either a reservation of rights or a non-waiver agreement. The purpose of offering a qualified defense is to permit the insurer to comply with its contractual obligation to defend while preserving its right to later contest coverage.

Reservation of Rights Letter:

A reservation of rights is a unilateral action whereby the insurer informs the policyholder in writing of the specific coverage issues. A reservation of rights letter informs the policyholder: (i) of the coverage defenses that the insurer may rely on to deny coverage; and (ii) that its defense of the policyholder does not waive these potential coverage defenses and/or estop the insurer from later raising them.

Third-Party Coverage:

Third-party coverage provides coverage for claims made against the insured by third parties for injuries to the third party or damage to the third-party's property. Examples of third-party coverage include the CGL policy, directors' and officers' liability policies, and errors and omissions policies.

Umbrella Insurance:

Umbrella policies often provide broader coverage than the underlying primary insurance policies. Umbrella policies differ from standard excess insurance policies in that they are designed to fill gaps in coverage by providing excess coverage and by providing primary coverage not provided in the true primary policy. Umbrella policies typically have larger limits than the primary policies that they sit above.

Unqualified Defense:

Offering to defend unqualifiedly means the carrier agrees that coverage exists under the policy and that it is not reserving any right to later deny a defense or indemnity obligation under the policy. By doing so, the insurer can demand compliance with all policy conditions and may also assert the right of exclusive control of the defense.

Wasting Policy:

A “wasting policy” is one in which the applicable policy limits are reduced by the costs and attorneys’ fees incurred in defending an action.