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The *Lamar Homes v. Mid-Continent* Case: Defining the "Property Damage" and "Occurrence" Requirements for Construction Defect Claims (and Bad Faith Too)

A. The Certified Questions

Perhaps no other insurance coverage issues have been litigated more in recent years than the "property damage" and "occurrence" issues in the context of construction defect litigation against an insured general contractor for the acts and/or omissions of its subcontractors. In fact, as of August 31, 2007, there had been *at least* twenty decisions in the residential construction defect context alone from the state appellate and federal district courts in Texas, with the results decidedly split. For that reason, and because courts across the country are split on these issues as well, the Fifth Circuit certified these issues (along with a bad faith issue) to the Supreme Court of Texas:

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

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

3. If the answers to certified questions1 and 2 are answered in the affirmative, does Article 21.55 of the Texas Insurance Code apply to a CGL insurer's breach of the duty to defend?

B. The Answers – Yes, Yes, and Yes

On August 31, 2007, in a 6-3 opinion, the Supreme Court of Texas handed down its long-awaited opinion. *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 2007 WL 2459193 (Tex. Aug. 31, 2007) ("[W]e conclude that allegations of unintended construction defects may constitute an 'accident' or 'occurrence' under the CGL policy and that allegations of damage to, or loss of use of, the home itself may also constitute 'property damage' sufficient to trigger the duty to defend under a CGL policy. We further

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CASES TO WATCH:

***Excess Underwriters at Lloyd's, London v. Frank's Casing Crew & Rental Tools, Inc.*, 2005 WL 1252321 (Tex. May 27, 2005) (pending on rehearing) (whether Texas recognizes a right of recoupment by an insurer against its insured)**

***Fairfield Ins. Co. v. Stephens Martin Paving*, 381 F.3d 435 (5th Cir. 2004) (certified to the Supreme Court of Texas and argued on November 9, 2004) (whether an award of punitive damages is insurable under an employers liability policy)**

***Ulico Cas. Co. v. Allied Pilots Ass'n*, 187 S.W.3d 91 (Tex. App.—Ft. Worth 2005, pet. granted) (argued on April 11, 2007) (whether Texas recognizes coverage by waiver and/or estoppel when an insurer undertakes the defense without adequately reserving rights)**

***American Home Assur. Co., Inc. v. Unauthorized Practice of Law Comm.*, 121 S.W.3d 831 (Tex. App.—Eastland 2003, pet granted) (argued on September 28, 2005) (scope of the tripartite relationship between insurer, insured, and defense counsel retained by insurer)**

conclude that the prompt-payment statute, formerly article 21.55, and now codified as sections 542.051–.061 of the Texas Insurance Code, may be applied when an insurer wrongfully refuses to promptly pay a defense benefit owed to the insured.").

Mid-Continent had set forth three main arguments against coverage—all of which were rejected by the Court. First, Mid-Continent argued that a CGL policy's purpose is to protect the insured from tort liability, not claims for defective performance under a contract. Second, Mid-Continent argued that defective work cannot be an "occurrence" because it is not accidental. In other words, according to Mid-Continent, a general contractor should expect that faulty workmanship will result in damage to the project itself. Third, Mid-Continent argued that extending CGL coverage to a general contractor for damage to the project itself transforms a CGL policy into a performance bond. *Id.* at *3.

As to the first argument, the Court correctly rejected any contract vs. tort distinction. In particular, the Court noted that the "economic-loss rule . . . is not a useful tool for determining insurance coverage." *Id.* at *8. Moreover, 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.'" *Id.* Simply put, the Court followed the long line of case law that had previously held that "the label attached to the cause of action—whether it be tort, contract, or warranty—does not determine the duty to defend." *Id.*

As to the second argument, the Court rejected "foreseeability" as "the boundary between accidental and intentional conduct." *Id.* at *4. 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." *Id.* (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.* at *5. Because no one alleged that Lamar Homes intended or expected its work or its subcontractors' work to damage the home, the Court concluded that the complaint in the underlying construction defect lawsuit alleged an "occurrence." *Id.*

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CASES TO WATCH: (continued)

***OneBeacon Ins. Co. v. Don's Building Supply, Inc.*, 2007 WL 2258192 (5th Cir. Aug. 8, 2007) (certifying trigger issue to the Supreme Court of Texas)**

As to the third argument, the Court correctly concluded that coverage under a CGL policy and a performance bond are not necessarily mutually exclusive:

> **Any similarities between CGL insurance and a performance bond under these circumstances are irrelevant, however. The CGL policy covers what it covers. No rule of construction operates to eliminate coverage simply because similar protection may be available through another insurance product.**

***Id.* at *6. With respect to the "property damage" requirement, 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*.**

One of the rationales relied on by the Court in answering the first two certified questions in the affirmative was the presence of the carefully-crafted business risk exclusions. *Id.* at *6–*7. The Court demonstrated that exclusions J5, J6, and L eliminate coverage for many construction-related losses. Even so, the "subcontractor exception" to exclusion L would be virtually meaningless if faulty workmanship could not be "property damage" caused by an "occurrence" in the first place. In this regard, the Court held that "when a general contractor becomes liable for damage to work performed by a subcontractor—or for damage to the general contractor's own work arising out of a subcontractor's work—the subcontractor exception preserves coverage that the 'your work' exclusion would otherwise negate." *Id.* at *7.

In reaching this conclusion, the Court analyzed the evolution of the CGL policy and noted that inclusion of the "subcontractor exception" language was a purposeful addition to the CGL policy. *Id.* Likewise, although not in the policy issued to Lamar Homes, the Court noted that ISO has promulgated an endorsement (CG 22 94) that eliminates the "subcontractor exception" to exclusion L. *Id.*

After deciding the first two certified issues in favor of Lamar Homes, the Court turned to the "prompt payment of claims" statute and, in particular, to the issue of whether a claim for breach of the duty to defend constitutes a "first-party claim" within the meaning of the statute. The majority of federal district courts had concluded that the statute—which provides for an 18% interest penalty per annum plus attorneys' fees—applied to a breach of the duty defend whereas a majority of the state appellate courts had concluded otherwise. In concluding that a claim for breach of the duty to defend is, in fact, a "first-party claim," the Court noted that "this loss belongs only to the insured and is in no way derivative of any loss suffered by a third party." *Id.* at *12. Further, the Court held that "first-party claim" is not synonymous with a claim under a "first-party insurance policy." *Id.* The Court further rejected the argument that the statute does not apply because the benefits are payable to the attorney rather than to the insured. *Id.* Likewise, the Court rejected the contention that the statute

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was "unworkable in the context of the insured's claim for defense benefits. *Id.* "As one amicus in this case submits, when the insurer wrongfully rejects its defense obligation, the insured has suffered an actual loss that is quantified after the insured retains counsel and begins receiving statements for legal services. These statements are the last piece of information needed to put a value on the insured's loss." *Id.* at *13.

C. The Dissent

The dissent, authored by Justice Brister and joined by Justices Hecht and Willett, focused on the economic loss rule, the business risk rationale, and a law review article published in 1961 in declining to find coverage. According to the dissent, "[s]*elling* damaged property is not the same as *damaging* property." *Lamar Homes*, 2007 WL 2459193, at *14. Stated otherwise, the dissent contends that "Lamar Homes was sued for breaking promises, not for breaking property." *Id*. at *17. Although it is contrary to what Lamar Homes argued, and to what the majority concluded, the dissent contended that "[e]very crack, stain, dent, leak, scratch, and short-circuit arising from a subcontractor's work (which will be most of them) must be repaired by the builder's insurer, who may have to pay the builder to repair its own home." *Id.* Such a contention is without merit and ignores the business risk exclusions. In addition, both in its briefing and at oral argument, Lamar Homes readily acknowledged that a mere defect—in and of itself—does not constitute "property damage."

Moreover, while the dissent concedes that "the CGL policy does not distinguish between contract and tort claims, or mention economic loss," it nevertheless would hold that allegations of defective construction do not constitute "property damage" because such allegations are for pure economic loss. *Id*. at *15. Likewise, the dissent concedes that "the subcontractor exception creates something of an anomaly when used in the construction industry" and that "the subcontractor exception has effectively rendered the CGL policy's your-work exclusion meaningless when issued to a general contractor," but nevertheless would rule against coverage based on the "property damage" definition. *Id.* at *16. This reasoning, of course, violates well-established contract interpretation principles that require the policy to be read as a whole and to give meaning to all parts of a policy.

Finally, while acknowledging that a split in authority exists, the dissent characterizes the Court's opinion as adopting a minority view. *Id.* The majority, on the other hand, contends that "[a]fter examining the dissent's list, we conclude that the dissent has neither discovered a majority rule nor analyzed this case to fit within it." *Id.* at *9.

The dissent did not address the article 21.55 issue.

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Commentary:

Although *Lamar Homes*, and many of the cases that preceded it, arose in the context of residential construction, its holdings are in no way limited to the residential construction defect context. Whether the insured is a homebuilder that builds ten homes a year or a large commercial contractor that builds stadiums, the definitions of "property damage" and "occurrence" are the same. Likewise, for the most part, the business risk exclusions are the same. Accordingly, at least in those policies that do not have endorsement CG 22 94 that eliminates the subcontractor exception, *Lamar Homes* should have far reaching implications on how defective construction claims are adjusted. In particular, virtually every construction defect claim against a general contractor implicates the "property damage" and "occurrence" requirements. Moreover, the "prompt payment of claims" statute will provide CGL insurers an incentive to think twice before denying a defense.

Although I am perhaps a bit biased, the majority opinion was well-reasoned and addressed every issue raised by Mid-Continent by applying the policy language as written. The dissent, on the other hand, relied on extraneous legal theories such as the economic loss rule and the business risk rationale and largely ignored the actual policy language.

Finally, while acknowledging that it has similar issues pending in six separate petitions for review, the Court issued only the *Lamar Homes* opinion. And, in fact, it granted the petition for review in *Pine Oak Builders, Inc. v. Great American Lloyds Insurance Company*, 2006 WL 1892669 (Tex. App.—Houston [14th Dist.] July 6, 2006, pet. granted). While *Pine Oak Builders* involves the same *Lamar Homes* issues, it also contains issues as to the proper "trigger" theory to be applied and the scope of the "eight corners" rule. Accordingly, since the Supreme Court accepted the certified questions in *OneBeacon Ins. Co. v. Don's Building Supply, Inc.*, 2007 WL 2258192 (5th Cir. Aug. 8, 2007) (certifying trigger issue to the Supreme Court of Texas) (addressed in Vol. 1:4 of the Insurance Law Newsletter), it makes sense that the Court granted the petition for review in *Pine Oak Builders*. In addition to the "trigger" issue, the *Pine Oak Builders* case involved a question of whether a court could go outside the "eight corners" of the pleading and the policy to determine whether the insured general contractor used subcontractors. *See Pine Oak Builders*, 2006 WL 1892669, at *6 (refusing to consider extrinsic evidence). In *Lamar Homes*, in what may be foreshadowing, the Court stated that "facts and circumstances must *generally* be gleaned from the plaintiff's complaint." *Lamar Homes*, 2007 WL 2459193, at *5 (emphasis added). Aside from *Pine Oak Builders*, it will be interesting to see whether the Court uses the other pending cases to further clarify its stance on the "property damage" and "occurrence" issues or whether it will simply issue one-page opinions that follow form to *Lamar Homes*. Only time will tell. Either way, it will provide me with an opportunity (read: excuse) to issue another Insurance Law Newsletter.

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Lee H. Shidlofsky represented Lamar Homes at the Fifth Circuit and in the Supreme Court of Texas. For a more thorough analysis of the issues in *Lamar Homes*, see *Lamar Homes v. Mid-Continent Casualty Company: Certifying the Certifiable*, 4:1 Constr. L. J. 21 (Summer 2006), which can be found under the Publications Tab at www.vsfirm.com.

GETTING TO KNOW LEE H. SHIDLOFSKY AND THE INSURANCE LAW PRACTICE GROUP ...

Lee H. Shidlofsky is a founding partner of Visser Shidlofsky LLP. His practice is devoted to representing and counseling corporate policyholders in the area of insurance law, risk management, contractual risk transfer, and extra-contractual issues. He is Treasurer of the Insurance Law Section and holds a council position in the Construction Law Section of the State Bar of Texas. He is the author of numerous articles and seminar papers and is a frequent speaker at continuing legal education seminars in Texas and across the country. Mr. Shidlofsky has been named a "Super Lawyer" by Texas Monthly Magazine each year since 2004 and is ranked as a top insurance coverage lawyer by Chambers USA and Who's Who Legal.

The Insurance Law Practice Group represents corporate policyholders that are in disputes with their insurance companies, provides advice to plaintiffs in complex litigation on how to best maximize an insurance recovery, and provides risk-management consultation in connection with a wide-variety of contractual risk transfer issues. The Insurance Law Practice Group handles first-party and third-party insurance claims in state and federal courts at both the trial and appellate court levels. The Insurance Law Practice Group is committed to practical and pragmatic solutions to insurance issues.

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