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LAMAR HOMES V. MID-CONTINENT:

The Supreme Court of Texas answers the three certified questions in favor of the insured and denies rehearing.

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The *Lamar Homes v. Mid-Continent* Case: Rehearing Denied

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 questions 1 and 2 are answered in the affirmative, does Article 21.55 of the Texas Insurance Code apply to a CGL insurer's breach of the duty to defend?

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.*, 236 S.W.3d 239 (Tex. 2007) ("[W]e conclude that allegations of unintended construction defects may constitute

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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)

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 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 242–43.

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 248. 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.* at 249.

As to the second argument, the Court rejected “foreseeability” as “the boundary between accidental and intentional conduct.” *Id.* at 244. 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

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CASES TO WATCH:

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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)

Pine Oak Builders, Inc. v. Great Am. Lloyds Ins. Co., 2006 WL 1892669 (Tex. App.—Houston [14th Dist.] July 6, 2006, pet. granted) (scope of the eight-corners rule and proper trigger theory to apply to "property damage" cases)

Johnson v. State Farm Lloyds, 204 S.W.2d 897 (Tex. App.—Dallas 2006, pet. granted) (scope of the standard appraisal clause)

Crocker v. National Union Fire Ins. Co. of Pittsburgh, Pa., 466 F.3d 347 (5th Cir. 2006) (certified to the Supreme Court of Texas and argued on January 25, 2007) (whether notice by the named insured inures to the benefit of an additional insured)

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 245. 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.*

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 246. 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.* at 245.

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 246–48. 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 247.

In reaching this conclusion, the Court analyzed the evolution of the CGL policy and noted that inclusion of the "subcontractor

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exception” language was a purposeful addition to the CGL policy. *Id.* at 248. 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 253. 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.* at 254. Likewise, the Court rejected the contention that the statute 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 255.

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*, 239 F.3d at 255. Stated otherwise, the dissent contends that “Lamar Homes was sued for breaking promises, not for breaking property.” *Id.* at 260. 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

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most of them) must be repaired by the builder's insurer, who may have to pay the builder to repair its own home." *Id.* at 256. 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 257. 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 258. 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.* at 259. 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 250–51.

At that time, the dissent did not address the article 21.55 issue.

D. Rehearing Denied and a Blistering Dissent by Justice Brister

The *Lamar Homes* case was finalized when the Court denied Mid-Continent's motion for rehearing on December 14, 2007. See *Lamar Homes v. Mid-Continent Cas. Co.*, 2007 WL 4357544 (Tex. Dec. 14, 2007) (denying rehearing). Justice Brister, who authored the dissenting opinion in the August 2007 *Lamar Homes* opinion that was joined by Justices Hecht and Willet, issued a second dissenting opinion upon the Court's decision to deny rehearing. "Since Reconstruction," Brister said, "prompt-payment penalties applied to some insurance claims in Texas, but never to a liability carrier's duty to defend. Now the Court discovers the Legislature accidentally changed all that when it tinkered with the statute in 1991, although no one apparently recognized it at the time. Nor

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could anyone have done so, as the three words the Legislature added in 1991 ('first-party claim') have never been used by anyone familiar with the insurance business to refer to the duty to defend." 2007 WL 4357544, at *1.

The entirety of Brister's dissent focused on the Court's decision to apply the prompt payment of claims statute (formerly article 21.55 of the Texas Insurance Code and now codified at TEX. INS. CODE art. 542.051-.061) to Lamar Homes' claim for a defense from its insurer. He argued that the defense claim is not a "first-party claim" under the statute because a liability policy is a third-party policy. The Court had rejected that view, though, because "first-party" modified "claim" and not "policy."

By the tone of his opinion, it is clear that Brister recognized the impact the majority's decision has on Texas insurance law. Prior to the *Lamar Homes* case, courts were split on whether the prompt payment statute applied to the denial of a claim for a defense. *Compare N. County Mut. Ins. Co. v. Davalo*, 84 S.W.3d 314, 318-19 (Tex. App.—Corpus Christi 2002) (applying the statute to a denial of a claim for a defense), *rev'd on other grounds*, 140 S.W.3d 685 (Tex. 2004), *with TIG Ins. Co. v. Dallas Basketball, Ltd.*, 129 S.W.3d 232, 239-241 (Tex. App.—Dallas 2004, pet. denied) (refusing to apply the statute to the denial of a claim for a defense). By agreeing that the statute applies in this situation, the Court's action was a significant victory for insureds, as it means that insurers now will think twice before denying a claim because a wrongful denial could result in the assessment upon insurers of a penalty of 18% interest.

While the Court adopted Lamar Homes' position, it arguably also made the workability of the statute in these situations cumbersome. The Court explained that an insured suffers an actual loss when its insurer wrongfully denies a defense obligation. That loss is quantified when the insured retains counsel and receives invoices for legal services. It is these invoices that complete the picture of the insured's loss and are the last piece of information needed by the insurer. Once the insurer receives those invoices and "fails to pay within the statutory deadline, the insured matures its right to reasonable attorney's fees and the eighteen percent interest rate specified by the statute." *Lamar Homes*, 239 S.W.3d at 255. Submitting legal bills to an insurer that already has denied coverage seems to be an unnecessary exercise. Moreover, in such a situation, a problem arises as the attorney fee invoices

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are privileged information to which the insurer is not privy in light of its coverage denial. While an insured could send a completely redacted invoice to the insurer, it seems obvious that the insurer then simply will inquire about the hours billed and the legal work completed. As the prompt payment statute is only triggered after the insurer has “receive[d] all items, statements, and forms required by the insurer to secure final proof of loss,” *id.* (citing TEX. INS. CODE §§ 542.056(a), 542.058), it will be interesting to see how the statute actually gets applied.

E. *Lamar Homes* and Other Recent Supreme Court Rulings: What Do They All Mean?

On the same day it denied rehearing in *Lamar Homes*, the Supreme Court of Texas also denied petitions for review in *Gehan Homes, Ltd. v. Employers Mutual Casualty Co.*, 146 S.W.3d 833 (Tex. App.—Dallas 2004, pet. denied), and *Lennar Corp. v. Great Am. Ins. Co.*, 200 S.W.3d 651 (Tex. App.—Houston [14th Dist.] 2006, pet. denied). And, on January 11, 2008, it denied the petition for review in *Archon Investments, Inc. v. Great American Lloyds Insurance Co.*, 174 S.W.3d 334 (Tex. App.—Houston [1st Dist.] 2005, pet. denied). *Gehan Homes* and *Archon Investments* involved issues nearly identical to those in *Lamar Homes*. Accordingly, the denial of those petitions was not surprising. The denial of the petition for review in *Lennar Corp.*, on the other hand, is significant because it was a case about an insurer’s duty to indemnify its insured in the construction defect context.

Together, *Lamar Homes* and *Lennar Corp.* set the framework for insurance coverage in construction defect cases. More specifically, the two opinions create a strong precedent for coverage for general contractors in the context of a completed operation when the damaged work or the work out of which the damage arises was performed on the insured’s behalf by a subcontractor.

F. The Aftermath

Less than a week after the Court’s decision to deny rehearing, the Florida Supreme Court promptly followed Texas’ lead in *U.S. Fire Ins. Co. v. J.S.U.B., Inc.*, 2007 WL 4440232 (Fla. Dec. 20, 2007). In *J.S.U.B.*, the Florida Supreme Court relied significantly upon the language in *Lamar Homes* in holding that a CGL policy provides coverage to a general contractor for property damage caused by a subcontractor’s defective work. *Id.* And, before that, in October 2007 the Houston 1st District Court of Appeals cited *Lamar Homes*

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for the proposition that “Texas law . . . requires that insurance policies be written in English, preferably plain English, not code.” *DaimlerChrysler Ins. Co. v. Jack Apple*, 2007 WL 3105899, at *10 n.20 (Tex. App.—Houston [1st Dist.] Oct. 25, 2007, no pet.) (quoting *Lamar Homes*, 239 S.W.3d at 249). These courts likely will be the first of many to rely upon the findings of the Supreme Court of Texas in *Lamar Homes*.

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.

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.



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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, including a ranking as a Top 50 attorney in the Central and West Texas Region for 2007, and is ranked as a top insurance coverage lawyer by Chambers USA and Who's Who Legal.

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