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IN THIS ISSUE:

ONEBEACON V. DON'S BUILDING SUPPLY:

The Supreme Court of Texas rules that the proper trigger theory for latent property damage claims is the "injury-in-fact" trigger, rejecting the manifestation trigger

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The Supreme Court Pulls the Trigger on Manifestation

In Volume 1, Issue 4 of the Insurance Law Newsletter, we discussed a "Change on the Horizon" with regard to the trigger issue as it relates to coverage under commercial general liability ("CGL") insurance policies. On August 29, 2008, the Supreme Court of Texas addressed the issue of what "trigger" applies under an occurrence-based insurance policy in the context of latent "property damage" claims. In *Don's Building Supply, Inc. v. OneBeacon Insurance Co.*, 2008 WL 3991187 (Tex. Aug. 29, 2008), a unanimous Court held that, absent specific policy language to the contrary, "property damage" under a CGL policy occurs when actual physical damage to the property occurs—not when the damage was or could have been discovered. In essence, the Court rejected a "manifestation" trigger in favor of an "injury-in-fact" trigger. Even so, the opinion left open some important questions as to how the "injury-in-fact" trigger will apply in the duty to indemnify context and, in particular, how it will apply to "property damage" that begins in one policy period but continues into periods covered by other policies.

A. Background Facts

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

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CASES TO WATCH:

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)

Mid-Continent Cas. Co. v. JHP Development, Inc., 2005 WL 1123759 (W.D. Tex. Apr. 21, 2005) (appealed to the Fifth Circuit Court of Appeals) (application of exclusions j(5) and j(6))

D.R. Horton—Texas, Ltd. v. Markel International Ins. Co., Ltd., 2006 WL 3040756 (Tex. App.—Houston [14th Dist.] Oct. 26, 2006, pet. filed) (scope of the eight-corners rule and the relationship between the duty to defend and the duty to indemnify)

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

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

B. The Certified Questions

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

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

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

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

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

Id. at *2. The policies further provide:

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

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

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

Id.

Looking at those provisions, and giving them their plain meaning, the Court held that property damage occurred when actual physical injury to the property at issue occurred. That is, property damage occurs at the time when a home that is the subject of an underlying lawsuit suffers wood rot or other physical damage. The Court found this to be true regardless of the date that the physical damage was or could have been discovered. The date of discovery, according to the Court, "is irrelevant." *Id.* at *3. In other words, the Court adopted what other courts have called the "actual injury" or "injury-in-fact" approach by which an insurer must defend any claim of physical property damage that occurred during the policy period. *Id.*

In adopting that trigger theory, the Court recognized the varying approaches adopted by other courts and the Fifth Circuit's note that the issue has not been uniformly resolved in Texas and across the country. *Id.* In particular, as it has long been the majority rule in Texas, the Court primarily discussed the "manifestation rule" that imposes a duty on an insurer only if property damage became evident or discoverable during the insurer's policy period. *Id.* The Court noted, though, that even the manifestation trigger has variations with some courts requiring actual discovery and others looking to when the damage *could have been* discovered. And, even then, courts taking the latter approach vary as to how easily discoverable the damage must be to trigger a duty to defend. *Id.* Importantly, the court discussed decisions in which courts use the word "manifest" and have been cited as adopting the manifestation rule even though such cases did not deal with *latent* property damage—the point at which the manifestation and the injury-in-fact trigger diverge.

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Id. The Court concluded that such cases actually can be read as adopting the same injury-in-fact trigger it adopted, and that their use of the word "manifest" is used as a synonym for "results in," "rather than [for] drawing a distinction between the actual occurrence of damage and the later discovery or obviousness of damage." *Id.*

The Supreme Court then acknowledged that two Texas appellate courts had adopted an "exposure rule" that triggers coverage so long as the plaintiff is exposed to the ultimately injurious agent during the insurer's policy period. *Id.* at *3. The Court, however, noted that "what some courts call the 'exposure rule' may actually be what others would call the injury-in fact rule." *Id.* Other courts adopt multiple or continuous triggers or, in the alternative, a rule that looks to the date of the negligent conduct rather than the resulting injury. Still others, like courts in California, adopt a manifestation rule under first-party insurance policies, but a continuous-injury rule under liability insurance policies. *Id.* Finally, the Court said: "A related if not overlapping body of law, which we do not explore today, addresses when coverage is triggered on bodily injury claims under CGL and other policies." *Id.*

As for the manifestation rule, which was the theory urged by OneBeacon and followed by most Texas courts, the Court said: "the policy before us simply makes no provision for it." *Id.* at *4. Looking at the plain language of the policy, the court found that "whatever practical advantages a manifestation rule would offer to the insured or the insurer, the controlling policy language *does not* provide that the insurer's duty is triggered only when the injury manifests itself during the policy term, or that coverage is limited to claims where the damage was discovered or discoverable during the policy period." *Id.* (emphasis added). In turn, at least in property damage cases, the Court also made clear that the policy language does not support the use of an exposure rule either. Notably, "[t]he policy does not state that coverage is available if property is, during the policy period, exposed to a process, event, or substance that *later results in* bodily injury or physical injury to tangible property." *Id.* (emphasis added).

Taking a literal approach to the policy language, the Court explained that "[t]his policy links coverage to damage, not damage detection." *Id.* And, by applying the manifestation rule, the Court was concerned that the line between occurrence-based and claims-made policies would be blurred. In any event, the Court noted that had insurers wanted a policy where coverage depends on manifestation of damage, then insurers could adopt such a policy and seek its approval from Texas insurance regulators. *Id.* Moreover, despite OneBeacon's claim that the manifestation rule is easier to apply, the Court said that it "does not eliminate the need to address sometimes nettlesome fact issues." *Id.* For example, at least one version of the manifestation rule requires proof not of when the claimant actually identified the damage, but when it was *capable* of such identification. *Id.* In that case, the injury-in-fact rule may be just as easy—if not easier—to apply than the manifestation rule.

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Further, in addressing the "ease of application" argument, the Court recognized that pinpointing the moment of injury retrospectively can be difficult in some cases, "but we cannot exalt ease of proof or administrative convenience over faithfulness to the policy language; our confined task is to review the contract, not revise it." *Id.* In addition, the Court found that its holding was consistent with scholarly authority. *Id.* at *5 (citing 7A JOHN ALAN APPELMAN, INSURANCE LAW AND PRACTICE § 4491.01 (Walter F. Berdal ed., 1979); 7 COUCH ON INSURANCE § 102.22)). As explained in COUCH ON INSURANCE, "the manifestation rule 'obviously gives short shrift to the specific terms inserted in the policy to address the risk exposure.'" *Id.* According to the Court, though, Texas law does not. *Id.* In closing its discussion of the first certified question, the Court made clear that it was not adopting a blanket rule for all CGL policies; instead, it held that an insurer's duty to defend should be determined by the language in the insurance policy, which can vary from one policy to another. *Id.*

Having adopted the injury-in-fact rule, the Court turned to the second certified question and promptly determined that OneBeacon had a duty to defend DBS in the underlying lawsuits. *Id.* In particular, the Court found that under the rule it had adopted, "a plaintiff's claim against DBS that *any amount* of physical injury to tangible property occurred during the policy period and was caused by DBS's allegedly defective product triggers OneBeacon's duty to defend." *Id.* at *6 (emphasis added). The Court further noted that the duty is "not diminished because the property damage was undiscoverable . . . until after the policy period ended." *Id.* Likewise, the Court held that the duty to defend is not dependent on whether "DBS has a valid limitations defense." *Id.*

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What the Court did not say is how many of the OneBeacon policies were triggered. In a footnote, the Court further explained that in the case before it, the defective EIFS was installed on the homes during the three-year policy period of the OneBeacon policies. *Id.* at *6 n.45. Accordingly, the Court concluded that it need not address a situation where property damage occurred during the course of a continuing process but began before inception of the policy at issue. *Id.* And, the Court declined to address OneBeacon's indemnity obligations should it be determined that the damage commenced during a OneBeacon policy period but continued beyond that period (perhaps into periods covered by other policies). *Id.*

Commentary:

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

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trigger certainly has caused confusion among courts, insureds, and insurers as to its correct application.

The opinion undoubtedly will result in a change as to how insurance carriers approach property damage claims—especially in the context of construction defect claims. Most, if not all, insurance carriers assumed that Texas was a manifestation state. Now, that assumption is no longer valid and insurers will have to re-examine their obligations to respond to "property damage" claims. An insurer, by way of example, can no longer deny coverage simply because the underlying claimant invokes the discovery rule. Similarly, an insurer can no longer deny coverage simply because the underlying claimant alleges "discovery" of the damage after the insurer's policy period has expired. Even so, the Court's opinion left open some important issues. For example, the Court did not address what would happen in circumstances where the property damage occurred in the course of a continuing process—but began before the inception of the term of the policy at issue. Likewise, in declining to address the duty to indemnify, the Court left open the issue of how insurers will adjust losses where property damage begins during the policy period but continues into other policy periods. Most likely, although not explicitly discussed, these issues will result in more frequent application of the "known loss" or "loss in progress" doctrines as well as application of specific policy language dealing with continuous losses that was incorporated into standard ISO forms in 2001 (f/k/a the "Montrose Endorsement"). The opinion likely also will result in a debate as to whether Texas follows an "all sums" approach to allocation or whether losses can be pro-rated among consecutively triggered policies. Finally, the Court was careful to limit its holding to the specific policy language before it. Accordingly, when dealing with manuscript forms, it will be important to carefully review the policy language before assuming that an injury-in-fact trigger applies. We will continue to keep you posted on further developments.

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NEW ATTORNEY JOINS VISSER SHIDLOFSKY

VISSER SHIDLOFSKY LLP is very proud to announce the recent hire of the newest member of the Insurance Law Practice Group—Melissa L. Kelly. Melissa comes to the firm with extensive federal litigation experience, which she gained while representing clients before the federal district courts of Texas, as well as the United States Court of Appeals for the Fifth Circuit. She is a 2006 graduate of Seton Hall University School of Law and she also spent some time as a visiting student at the University of Texas School of Law. Before attending law school, Melissa graduated *magna cum laude* from William Paterson University with a Bachelor's of Science in Business Administration. She had a concentration in Finance and a minor in Economics.

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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. Lee 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. Lee was recently elected a Fellow of the Texas Bar Foundation.

Douglas P. Skelley and Melissa L. Kelly are associates at Visser Shidlofsky LLP. They each represent and counsel corporate policyholders in numerous insurance law matters. Doug and Melissa are members of both the Insurance Law Section and the Construction Law Section of the State Bar of Texas.

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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