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Many of you have written and asked us why we dropped you from the newsletter distribution list. You have not been dropped. Let's just say that we have been blessed with a lot of work this past year and the newsletter took a backseat. The fact that so many of you have written about missing the newsletter either means that you need better reading material or just need help falling asleep at night. Regardless, we are going to do our best to get the newsletter out on a more regular basis. And to make up for the last few (read: many) months, we attach a paper that will catch everyone up (or help you go to sleep).

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**2010 INSURANCE LAW
UPDATE**

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

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**AN UPDATE¹ ON RECENT INSURANCE COVERAGE DECISIONS
AND THEIR IMPACT ON THE CONSTRUCTION INDUSTRY:**

THE POLICYHOLDERS' PERSPECTIVE

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¹ Let's just pretend this was a *monthly* newsletter, instead of the *annual* newsletter it became.

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I. *Wilshire Insurance Co. v. RJT Construction, LLC*, 581 F.3d 222 (5th Cir. 2009)

On August 26, 2009, the Fifth Circuit Court of Appeals issued a short but important opinion in *Wilshire Insurance Co. v. RJT Construction, LLC*, 581 F.3d 222 (5th Cir. 2009). The opinion addressed recent Texas law regarding when a CGL policy is triggered. In addition, the court interpreted the subsidence and your work exclusions in the insured's policy.

A. Background Facts

In 1999, RJT Construction repaired a foundation at the home of William Ashbaugh. Six years later, Ashbaugh alleged cracks appeared in his walls and ceiling because the foundation was not level. In 2007, Ashbaugh sued RJT for its negligent work on the foundation. RJT sought a defense and indemnity from Wilshire Insurance Co., which issued consecutive CGL policies to RJT from 2004 to 2006. Wilshire filed the instant declaratory judgment action, contending it did not owe a defense or indemnity to its insured. On summary judgment in the district court, Wilshire prevailed, as the court found the subsidence exclusion barred coverage.

B. Property Damage During the Wilshire Policy Periods

On appeal, the Fifth Circuit first addressed whether an occurrence took place within the policy period. The court explained that coverage only existed for property damage that “occurs during the policy period” and, according to the Supreme Court of Texas, “[o]ccurred means when *damage* occurred, not when *discovery* occurred.” *Id.* at 225 (quoting *Don's Building Supply, Inc. v. OneBeacon Ins. Co.*, 267 S.W.3d 20, 30 (Tex. 2008)). The court rejected Wilshire's argument that the underlying pleadings did not allege property damage occurred during the policy period. *Id.* The court said:

The complaint alleges that “cracks in the walls and ceilings” were “suddenly appearing” in late 2005. The cracks themselves are physical damage allegedly caused by the faulty foundation. This is not a case where latent internal rot long lies undiscovered before external signs warn of the festering damage. The cracks are not merely a warning of prior undiscovered damage; they are the damage itself. It is of no moment that the faulty foundation work occurred in 1999, or that the damage was discovered in 2005; it matters only that damage was alleged to have occurred in 2005. The complaint's allegations trigger coverage unless an exclusion is applicable.

Id. (footnotes omitted).

C. Policy Exclusions

Having found the Wilshire policy was triggered, the court turned its attention to the subsidence exclusion, which Wilshire contended precluded coverage. The exclusion bars coverage for damages “caused by, resulting from, attributable or contributed to, or aggravated by the subsidence of land as a result of landslide, mudflow, earth sinking or shifting, resulting from your operations or your subcontractor's operations.” *Id.* at 225–26. The district court applied the exclusion, finding the foundation movement would not have occurred but for the faulty repair of the foundation. The Fifth Circuit criticized the district court's holding, noting the exclusion

focuses on the movement of land, not movement of foundations. *Id.* at 226. RJT’s operations did not result in earth movement though; rather, RJT’s work failed to stop the foundation from moving. Thus, the exclusion was not applicable. *Id.*

Wilshire also relied on the “your work” exclusion, arguing it barred coverage for the underlying claims. Again, the court disagreed, noting the exclusion only bars coverage for the costs incurred to repair RJT’s own work. *Id.* The exclusion does not preclude coverage for damage to other property that resulted from the defective work. *Id.* Because the underlying pleadings allege that RJT’s work caused damage to other parts of the house on which RJT did not work, the exclusion did not bar coverage for all the damages. As such, Wilshire had a duty to defend the entire lawsuit against RJT. *Id.* at 227.

D. Commentary

The Fifth Circuit’s decision in *RJT* is an important one because it reiterates Texas law regarding what constitutes “property damage” under a CGL policy. Additionally, especially for contractor insureds, the court’s discussion of the limit of the “your work” exclusion is notable. As the court emphasized, the exclusion only bars coverage for the work performed by the insured—it does not extend to preclude coverage for damage to property beyond the scope of the insured’s work. As will be seen throughout this paper, the court’s holding in *RJT* has been relied on extensively the past year.

II. *Essex Insurance Co. v. Hines*, 358 F. App’x 596 (5th Cir. 2010)

On January 4, 2010, the Fifth Circuit Court of Appeals had “occasion once again to take up the ‘seemingly simple task’ of determining whether an insurance company owes a duty to defend an underlying liability lawsuit.” *Essex Insurance Co. v. Hines*, 358 F. App’x 596, 596–97 (5th Cir. 2010). Because the court found the insurer had such a duty, “it [was] also an occasion to again remind: ‘When in doubt, defend.’” *Id.* at 597.

A. Background Facts

In 2004, Jackie Hines purchased an insurance policy from Essex Insurance Co. to cover a house she owned in Corpus Christi, which provided both CGL and commercial property coverage. *Id.* During the policy period, she renovated the house and then sold it to a third party in August 2005. *Id.* The purchasers filed suit against Hines, alleging the renovation work was negligent and resulted in damage to the home. *Id.* Hines requested that Essex defend her in the suit, but Essex refused and filed the instant declaratory judgment action. *Id.* The district court found in favor of Hines, ruling that Essex owed her a defense. *Id.*

B. Duty to Defend Analysis

Essex first argued the policy did not provide coverage because the “classification” on the policy was “DWELLING – SINGLE FAMILY – LESSOR’S RISK ONLY.” *Id.* at 598. Essex contended that classification, along with the policy’s “Classification Limitation Endorsement” and “Limitation of Coverage to Designated Premises or Project,” precluded coverage for construction work. *Id.* While not implausible, the court found the “Renovated Property Endorsement” suggested otherwise, as it clearly provided: “This policy covers a renovation

project. This policy will cover the usable existing structure which predates the renovation project as insured property.” *Id.* Thus, the more reasonable interpretation of the policy was that it covered construction work. *Id.* “Suffice to say, that if a ‘Commercial General Liability Coverage’ policy taken out by a contractor is not generally intended to cover ‘construction,’ it might surprise the Texas Supreme Court; it seems to treat this conclusion as axiom.” *Id.* at 598–99 (citing *Pine Oak Builders, Inc. v. Great American Lloyds Ins. Co.*, 279 S.W.3d 650, 651 (Tex.2009) (citing *Lamar Homes, Inc. v. Mid-Continent Casualty Co.*, 242 S.W.3d 1, 4–5, 16 (2007))).

The court then addressed the exclusions raised by Essex. *Id.* at 599. The court rejected Essex’s reliance on the “expected or intended injury” exclusion because the underlying plaintiffs sued Hines for negligence, which does not involve an expected or intended act. *Id.* (citation omitted). The court also found exclusion J(6) did not apply because Fifth Circuit precedent is clear that that exclusion is limited by the inclusion of “that particular part” language, which “limits the scope of the exclusion to damage to parts of the property that were actually worked on by the insured.” *Id.* (quoting *Mid-Continent Casualty Co. v. JHP Development, Inc.*, 557 F.3d 207, 214 (5th Cir.2009)). Because the homeowners sought damages for more than just the repair of Hines’ renovation work, the exclusion did not apply. *Id.* at 599–600.

C. Commentary

The *Hines* decision is most notable for its opening paragraph in which the court reminded insurers that “[w]hen in doubt, defend.” Texas law on the duty to defend favors insureds and the court’s decision in *Hines* reminds insurers of that fact. The decision also is notable because of the court’s recognition that CGL policies do, in fact, cover construction work performed by insureds. Finally, the court reiterated Texas law limiting the scope of exclusion J(6) to “that particular part” on which the insured actually worked and allowing coverage for damage to property beyond that scope.

III. *David Lewis Builders, Inc. v. Mid-Continent Casualty Co.*, 2010 WL 1286544 (N.D. Tex. Apr. 1, 2010)

On April 1, 2010, Judge John McBryde of the U.S. District Court for the Northern District of Texas issued an opinion addressing Mid-Continent Casualty Co.’s motion for summary judgment, seeking a declaration that the CGL policy it issued to David Lewis Builders (“Lewis”) did not obligate it to defend or indemnify its insured in an underlying lawsuit brought by the owners of a house built by Lewis. While otherwise innocuous, the opinion is notable for Judge McBryde’s comments regarding Texas’ “eight corners” rule.

A. Background Facts

Lewis contracted with the Blakes to build a house. During construction of the house, it was damaged because of an increase in water beneath the ground surface of the foundation. *Id.* at *1. Lewis then contracted with the Blakes to repair the house at a cost of more than \$500,000, of which a portion was to be paid by one of Lewis’ subcontractors. Lewis sought coverage for the remaining cost as damages under the CGL policy. Mid-Continent denied coverage for the claim

citing the CGL policy's contractual liability exclusion, exclusion J(5), exclusion J(6) and exclusion L.

B. No Coverage Exists under the CGL Policy

At the outset, Judge McBryde addressed the basis of the Blakes' underlying lawsuit against Lewis. In particular, the court noted all the claims against Lewis arose out of Lewis' contract with the Blakes to build the home at issue. Essentially, the court explained, Lewis sought coverage from Mid-Continent for "costs required to complete the proper performance of its construction contract with the Blakes." *Id.* at *5.

Because Mid-Continent did not argue the insuring agreement was not satisfied by the claims asserted against Lewis, the court turned to the exclusions raised by Mid-Continent in denying coverage. First, the court addressed the "contractual liability" exclusion, which precludes coverage for damages "by reason of the assumption of liability in a contract or agreement." *Id.* Notably, the court found a reasonable construction of the exclusion existed such that it precluded coverage for the breach of contract claim made by the Blakes against Lewis, but the Fifth Circuit Court of Appeals and at least one state appellate court in Texas have said the exclusion can be interpreted such that it does not preclude breach of contract claims. *Id.* at *6 (discussing *Federated Mut. Ins. Co. v. Grapevine Excavation, Inc.*, 197 F.3d 720, 726 (5th Cir. 1999); *Lennar Corp. v. Great Am. Ins. Co.*, 200 S.W.3d 651, 693 (Tex. App.—Houston [14th Dist.] 2006, pet. denied)). "Therefore, though the court suspects that the true intent of the insurance company might well have been ignored in the court opinions mentioned above, the court considers that it has no choice but to follow the Fifth Circuit and Texas court precedent that leads to the conclusion that the contractual liability exclusion does not exclude from coverage the Blakes' claim against Lewis."² *Id.*

Second, the court addressed exclusions J(5) and J(6) of the CGL policy. In doing so, the court noted the claims by the Blakes against Lewis were exactly the type of claims for which the exclusion were meant to preclude liability on the part of Mid-Continent under the policy. *Id.* at *7. At their core, the allegations against Lewis were that Lewis failed—perhaps through the use of a subcontractor—to design the foundation such that it would not deflect during expansion of the soil under the foundation. *Id.* Exclusion J(6) applied because the "work"—i.e., the house—was not part of the "products-completed operations hazard" under the policy, as the damages at issue occurred prior to the completion of the work. *Id.* at *8. Additionally, Exclusion J(5) precluded coverage because "Lewis was performing operations on the real property (the building on the land owned by the Blakes), the damage was to the building (which was that particular part of the real property on which Lewis and its subcontractor were performing operations), and the damage of which the Blakes complained arose out of those operations, i.e., the design and placement of the foundation." *Id.* As such, the Blakes lawsuit against Lewis did not seek "damages because of . . . 'property damage' to which [Mid-Continent's] insurance applies." *Id.* Therefore, summary judgment on Mid-Continent's behalf was proper.

² Subsequently, in *Gilbert Texas Construction, L.P. v. Underwriters at Lloyd's London*, 2010 WL 2219645 (Tex. June 4, 2010) the Supreme Court of Texas handed down an opinion that could be interpreted as supporting Judge McBryde's "suspected" interpretation of the contractual liability exclusion. Scary.

Third, the court addressed the “your work” exclusion, which precludes coverage for damage to the work itself and included in the “products-completed operations hazard.” *Id.* at *9. Judge McBryde interpreted the exclusion as being meant to fill in any gaps left by the wording of exclusions J(5) and J(6). *Id.* Because the “property damage” at issue did not fall within the “products-completed operations hazard,” the court refused to rule in Mid-Continent’s favor on that exclusion.

Nevertheless, because Exclusions J(5) and J(6) applied to bar coverage, the court granted Mid-Continent’s motion for summary judgment. The court reasoned that Mid-Continent’s defense duty extended only to suits seeking damages because of “property damage” to which the insurance applies. *Id.* In doing so, the court noted:

As part of Mid-Continent's argument that it does not have a defense obligation, Mid-Continent devotes attention to what the Texas courts call the “eight corners” rule. Mid-Continent argues against a duty to defend on the assumption that such a rule applies in this case. The court would agree that even if the “eight corners” rule did apply to this case, Mid-Continent would not have a defense obligation. However, the court notes that Mid-Continent has overlooked the fact that the wording of the defense obligation in its insurance policy is such that the “eight corners” rule does not apply to the defense obligation imposed by its policy. *See B. Hall Contracting Inc. v. Evanston Ins. Co.*, 447 F.Supp.2d 634, 644-46 (N.D.Tex.2006), *rev'd on other grounds*, *B. Hall Contracting Inc. v. Evanston Ins. Co.*, 273 Fed.Appx. 310 (5th Cir.2008).

Id. at *9, n.3.

C. Commentary

Again, this opinion likely would have had little significance if not for the court’s footnote regarding the “eight corners” rule. Judge McBryde’s commentary that the “eight corners” rule somehow did not apply to the defense obligation imposed by the policy, especially when neither party raised it, is notable and wrong. Of course, in reaching that conclusion, Judge McBryde relied only on his own prior opinion—*B. Hall Contracting*—in which he made a similar finding. Judge McBryde’s opinion flies in the face of well-established Texas law, which specifically holds that an insurer’s duty to defend under a standard CGL policy is governed by the “eight corners” rule. *See Zurich Am. Ins. Co. v. Nokia, Inc.*, 268 S.W.3d 487, 491 (Tex. 2008); *GuideOne Elite Ins. Co. v. Fielder Road Baptist Church*, 197 S.W.3d 305, 308 (Tex. 2006); *Nat’l Union Fire Ins. Co. v. Merchants 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).

IV. *Lexington Insurance Co. v. North American Interpipe, Inc.*, 2010 WL 1558609 (S.D. Tex. Apr. 19, 2010)

On April 19, 2010, the Southern District of Texas issued its opinion on cross-motions for summary judgment in *Lexington Insurance Co. v. North American Interpipe, Inc.*, 2010 WL 1558609 (S.D. Tex. Apr. 19, 2010). The opinion addressed the definition of “occurrence” and Exclusion K—the “your product” exclusion.

A. Background Facts

North American Interpipe, Inc., f/k/a Sepco Tubulars (“NAI”) was the named insured on a CGL policy issued by Lexington Insurance Co. (“Lexington”). NAI had been sued in Colorado state court as a result of a damage claim where a piece of NAI casing ruptured in a natural gas well owned by Ultra Resources, Inc. (“Ultra”), allegedly causing Ultra approximately \$1.7 million in damages. Lexington agreed to defend NAI subject to a reservation of rights pending resolution of the instant declaratory judgment action. Ultra settled with NAI for \$610,149.83 and Lexington consented to the settlement subject to a mutual reservation of rights “regarding coverage issues.” *Id.* at *1. In the insurance dispute, Lexington and NAI filed cross-motions for summary judgment on the issue of coverage under the policy.

B. The “Occurrence” Issue

Lexington argued the failure of the NAI casing was not an “occurrence” under the policy and thus there was no coverage. The policy defined “occurrence” as “an accident, including continuous or repeated exposure to substantially the same general harmful conditions.” *Id.* at *2. Because the Policy did not define “accident,” the court interpreted it based on the “generally accepted or commonly understood meaning.” *Id.* (citing *Nat’l Union Fire Ins. Co. of Pittsburgh, Pa. v. Puget Plastics Corp.* (“*Puget I*”), 532 F.3d 398, 402 (5th Cir. 2008)). The court further elaborated: “An accident is generally understood to be a fortuitous, unexpected, and unintended event.” *Id.* (quoting *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 242 S.W.3d 1, 8 (Tex. 2007)). At the same time, “a claim does not involve an accident or occurrence when . . . 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.* (quoting *Lamar Homes*, 242 S.W.3d at 9. Mere foreseeability, however, was not “the boundary between accidental and intentional conduct.” *Id.* (quoting *Lamar Homes*, 242 S.W.3d at 8). In short, the court stated that if the circumstances confirmed that failure of NAI’s casing was the “natural and expected result” of their manufacturing process, then the casing’s failure would not qualify as an “occurrence,” and no coverage would apply to their claims. *Id.* at *3.

Lexington argued NAI knew the casing would fail because of a known defect in the manufacturing process that NAI previously had disclosed to Lexington. Based on the disclosure, Lexington agreed to a policy endorsement that excluded only “the recalled product that was produced” at the Ukrainian plant where the defect originated. *Id.* at *3. The court found the evidence proved the casing at issue did not come from that plant. Further, the court rejected Lexington’s belief that—because the failed casing at issue was produced before the repair process implemented at the Ukrainian plant—NAI necessarily should have expected the casing to fail. *Id.* The court determined that in the absence of any evidence that NAI knew or should have

known the casing in the Ultra well would fail, NAI was entitled to summary judgment that the loss was covered under the Policy.

C. Exclusion K

Lexington also argued Exclusion K precluded coverage for liability arising from “property damage to ‘your product’ arising out of it or any part of it.” *Id.* at *4. The court relied on the well-established definition of the exclusion that it excludes coverage for liability for the repair or replacement of the insured’s own product, but does not exclude coverage for liability resulting from damage to *other* property because of the defective product. *Id.* (citing *Zurich Am. Ins. Co. v. Nokia, Inc.*, 268 S.W.3d 487, 500 (Tex. 2008); *T.C. Bateson Constr. Co. v. Lumbermens Mut. Cas. Co.*, 784 S.W.2d 692, 694–95 (Tex. App.—Houston [14th Dist.] 1989, writ denied); 9A Lee R. Russ & Thomas F. Segalla, *COUCH ON INSURANCE* § 129:16 (3d ex. 2005); *Nat’l Union Fire Ins. Co. of Pittsburgh, Pa. v. Puget Plastics Corp.* (“*Puget II*”), 649 F. Supp. 2d 613, 649–50 n. 70 (S.D. Tex. 2009)). The court recognized it was uncontested that some portion of Ultra’s damages was excluded under the policy because it arose from removing and replacing the defective casing, but a genuine issue of material fact existed as to what portion of the settlement was reasonably intended to concern claims covered by the policy. *Id.* Thus, the court denied the cross-motions for summary judgment on that issue.

D. Commentary

The *Interpipe* decision continued a trend in 2010 of Texas courts analyzing what constitutes an “occurrence” and the scope of the “your product” exclusion. Without evidence that an insured knew or should have known that its product would fail, an “occurrence” exists when that product fails and damage results. The scope of covered damage, though, is governed by the exclusions in the policy—and, in particular in this case, the “your product” exclusion. As other courts have noted, the exclusion only precludes damages for repair or replacement of the product itself—it does not extend to damage beyond the product.

V. *Building Specialties, Inc. v. Liberty Mutual Fire Insurance Co.*, 712 F. Supp. 2d 628 (S.D. Tex. 2010)

On May 17, 2010, the Southern District of Texas issued an opinion addressing whether Liberty Mutual Fire Insurance Co. owed a defense and indemnify to its insured for the claims asserted in an underlying suit based on the damage caused by an improperly installed air conditioning system. *See Building Specialties, Inc. v. Liberty Mutual Fire Ins. Co.* 712 F. Supp. 2d 628 (S.D. Tex. 2010). After the underlying case settled, the court granted Liberty Mutual’s motion for summary judgment and denied Building Specialties’ cross-motion. In reaching its decision, the court evaluated whether repairing and replacing other property to reach the faulty air conditioning system was an “occurrence,” which constituted “property damage” and whether any exclusion within the policy precluded Liberty Mutual’s duty to defend and indemnify Building Specialties.

A. Background Information

Building Specialties was hired by Lone Star Refrigeration, Inc. (“Lone Star”) to install heating and air conditioning insulation in a residential construction project in Houston, Texas.

The materials were provided by Knauf Insulation GMBH (“Knauf”). *Id.* at 631. According to an affidavit from Building Specialties’ president, John Juzswik, the homeowner and Lone Star asserted that in the ballroom of the home, water or condensate was leaking from the air conditioning grills and damaging an expensive hardwood floor. *Id.* at 631–32. To repair the air conditioner, the entire ceiling had to be demolished to identify the source of the leak or condensation and remedy it. The estimated cost to tear down the ceiling, identify and fix the problem, and rebuild and repaint the ceiling was \$215,000. *Id.* at 632. No mention of repairing the hardwood floor was made in the affidavit. *Id.*

In September 2007, Lone Star sued Building Specialties and Knauf in Texas state court. In the original petition, Lone Star alleged that Building Specialties “designed and installed the heating and air conditioning duct work for the project” and that “[s]hortly after the system began operating, defects in the installation of the duct work were discovered.” *Id.* Lone Star alleged that it “undertook efforts to minimize the damage to repair and replace the defective product and/or installation.” *Id.*

Building Specialties forwarded the suit to Liberty Mutual for a defense and indemnity. *Id.* In April 2008, Liberty Mutual replied, arguing that Lone Star did not “allege that the duct work, or any other portion of the home, was damaged; only that the duct work required repair or remedy in order to work in the manner that Lone Star alleges it had hired BSI to design, manufacture and install to meet the homeowner’s expectations.” *Id.* Liberty Mutual denied coverage, claiming there was no “occurrence,” no “property damage,” and exclusions K (Damage to Your Product), L (Damage to Your Work) and M (Impaired Property) applied to preclude coverage. *Id.* at 632–33. Finally, Liberty Mutual asserted the professional liability exclusionary endorsement in the policy precluded coverage to the extent the lawsuit arose out of Building Specialties’ design of the HVAC system. *Id.* at 633.

Lone Star and Knauf eventually settled their claims and Lone Star filed an amended petition that removed all references to a defective product (the flooring), but left allegations that Building Specialties defectively installed the duct work. *Id.* Building Specialties eventually settled the underlying claim with Lone Star for \$60,000 and the coverage suit followed. *Id.*

B. “Occurrence”: Specific Words Not Required

The court began its analysis of the coverage issues by addressing the question of whether an “occurrence” existed, as that term is defined in the standard CGL policy at issue. *Id.* at 637. The district court adopted the Supreme Court of Texas’ reasoning in *Lamar Homes, Inc. v. Mid-Continent Casualty Co.*, 242 S.W.3d 1, 9 (Tex. 2007), where the Court observed that, in the absence of an allegation that the homebuilder intended or expected its work or its subcontractors’ work to damage the home, the underlying litigation alleged an “occurrence.” *See Building Specialties*, 712 F. Supp. 2d at 638 (citing *Lamar Homes*, 242 S.W.3d at 9). In the instant case, the court explained Lone Star did not allege the defective insulation duct work was a product of negligence by Building Specialties, but the lack of use of “negligent,” “unintentional” or “accidental” in the pleading did not necessarily mean there was no “occurrence.” *Id.* In *Lamar Homes*, the Court’s opinion was not clear whether the focus was on the presence of negligence allegations or the lack of intent allegations, “or whether either is necessary or sufficient.” *Id.* The court noted the underlying petition did not allege “that Building Specialties *intentionally* or

negligently designed or installed the duct work in a defective manner.” *Id.* at 639. “When an underlying petition does not include allegations clearly showing that the case is within or without coverage, the insurer is obligated to defend if there is potentially a case within the policy coverage.” *Id.* (citing *Trinity Universal Ins. Co. v. Employers Mut. Cas. Co.*, 592 F.3d 687, 693 (5th Cir. 2010)). As a matter of law, the absence of a negligence allegation does not defeat the duty to defend. *Id.* Additionally, the resolution of the underlying suit did not show that there was not an “occurrence.” *Id.* Thus, the court denied both parties’ cross-motions for summary judgment on the issue. *Id.*

C. “Property Damage”: Repair not Sufficient

The court then turned its attention to whether “property damage” was alleged in the underlying petition. Again, the court looked to the decision in *Lamar Homes* where a defective foundation resulted in cracks to the house’s sheetrock and stone veneer. Although such property was part of the insured’s work, the damage still constituted “property damage.” *Id.* at 640 (citing *Lamar Homes*, 242 S.W.3d at 9–10. “‘Property damage’ did not depend on whether the underlying claim was in tort or contract or on who owned the property that was physically injured.” *Id.* (citing *Lamar Homes*, 242 S.W.3d at 10). The federal district court noted, however, that *Lamar Homes* did not discuss whether the defective foundation or construction could constitute “property damage” without allegations that the defective foundation caused damage to the other parts of the home. *Id.*

In *Building Specialties*, the underlying petition only alleged defective installation of the insulation duct work. *Id.* “The only damages alleged and sought were “‘for payment for the additional work to remedy the problem and fix the damage.’” *Id.* The petition did not mention any damage to the hardwood floor or requests to cover the cost of repairing and replacing the floor, but were limited to costs to repair the defective work. *Id.* Building Specialties attempted use of an affidavit from its president, in which he claimed Lone Star said water had leaked through the diffusers and damaged the hardwood floor, was not admissible under Texas law for purposes of the duty to defend. *Id.* (citing *Pine Oak Builders, Inc. v. Great Am. Lloyds Ins. Co.*, 279 S.W.3d 650, 653 (Tex. 2009) (explaining Texas’ “eight corners” rule and refusing to adopt an exception to the rule)). Like in *Pine Oak*, according to the district court, the evidence sought to be admitted in *Building Specialties* contradicted the claims and allegations in the underlying suit and, therefore, Building Specialties could not rely on it to trigger a duty to defend. *Id.* at 641.

Looking only to the allegations in the underlying petition, then, the court was faced with a question that it considered to be unresolved by *Lamar Homes*: “[W]hether allegations of the insured’s faulty installation work and damages to repair only that work (with no damage to or damages for repairing other property alleged) could be ‘property damage.’” *Id.* While *Lamar Homes* did not directly address the issue, the Court did state:

Some basis exists, however, for the district court’s assumption that CGL insurance is not for the repair or replacement of the insured’s defective work. The assumption proves true in many cases because several acts of faulty workmanship do not fall within coverage, either because they are not an “occurrence,” “accident,” or “property damage,” or they are excluded from coverage by specific exclusions. For example, faulty workmanship that is intentional from the

viewpoint of the insured is not an “accident” or “occurrence,” and faulty workmanship that merely diminishes the value of the home *without causing physical injury or loss of use* does not involve “property damage.”

Id. (quoting *Lamar Homes*, 242 S.W.3d at 10) (emphasis added).

Liberty Mutual cited *Lennar Corp. v. Great American Insurance Co.*, 200 S.W.3d 651 (Tex. App.—Houston [14th Dist.] 2006, pet. denied), to support its argument that defective installation, standing alone, does not constitute “property damage.” In *Lennar*, the court considered whether a homebuilder's claims arising out of the use of an allegedly defective exterior insulation and finish system were covered “property damage.” The court held the cost to remove and replace the defective insulation on all homes as a way to prevent future damage to those homes was not property damage. *Id.* at 678–79. The *Building Specialties* court rejected Building Specialties’ argument that *Lennar Corp.* no longer applies in light of *Lamar Homes*. The ruling in *Lamar Homes* that physical injury to tangible property that is the insured’s work *can* be “property damage,” but that “does not mean claims arising out of the insured’s work *are* ‘property damage’ in every case.” *Building Specialties*, 712 F. Supp. 2d at 642. In each case relied on by Building Specialties, the underlying plaintiffs alleged some sort of property damage beyond the allegedly defective work of the insured. *Id.* at 643 (citing *Home Owners Mgmt. Enters., Inc. v. Mid-Continent Cas. Co.*, 294 F. App’x 814 (5th Cir. 2008); *Rotella v. Mid-Continent Cas. Co.*, 2008 WL 2694754 (N.D. Tex. July 10, 2008); *Pine Oak Builders, Inc. v. Great Am. Lloyds Ins. Co.*, 279 S.W.3d 650 (Tex. 2009)).

Building Specialties also argued *National Union Fire Insurance Co. of Pittsburgh, Pennsylvania v. Puget Plastics Corp.*, 532 F.3d 398 (5th Cir. 2008), should apply because Building Specialties believed it stood “for the proposition that repair or replacement of the insured’s allegedly defective work must be ‘property damage’ because the [Fifth Circuit] would not have discussed whether an exclusion applied without first concluding that there was covered ‘property damage.’” *Building Specialties*, 712 F. Supp. 2d at 644. The federal district court found *Puget Plastics* did not support Building Specialties because the first opinion in that case did not discuss whether covered “property damage” existed where undamaged water chambers were replaced because the “impaired property” exclusion applied. *Id.* (citing *Nat’l Union Fire Ins. Co. v. Puget Plastics Corp.*, 450 F. Supp. 2d 682, 696 (S.D. Tex. 2006), *aff’d*, 532 F.3d 398 (5th Cir. 2008)). In other words, in *Puget Plastics*, “the court relied on an exclusion not at issue in this case and did not decide whether there were allegations of ‘undamaged’ water chambers or whether the costs of removing undamaged water chambers were covered ‘property damage.’” *Id.* at 645.

The mere allegation that the duct work was defective and had to be replaced and the lack of allegations of any resulting physical damage to the duct work or other parts of the house did not rise to the level of alleging “property damage.” Because the court concluded the petition did not allege “property damage,” no duty to defend existed as a matter of law. Turning to the duty to indemnify, which could exist in the absence of the duty to defend, *see D.R. Horton-Texas, Ltd. v. Markel International Insurance Co.*, 300 S.W.3d 740, 743–44 (Tex. 2009), the court noted evidence outside the pleadings could be used to establish this duty. *Building Specialties*, 712 F. Supp. 2d at 645–46. The only additional evidence of property damage relied on by Building

Specialties was its president's affidavit, which Liberty Mutual argued was inadmissible hearsay and the court agreed. Thus, Liberty Mutual also did not have a duty to indemnify. *Id.* at 646.

D. The Exclusions

Although the court already had determined no duty to defend and no duty to indemnify existed, it addressed Liberty Mutual's alternative arguments that exclusions in the policy precluded coverage. Each exclusion was discussed in turn.

1. Exclusion K

Exclusion K applies to “[p]roperty damage to ‘your product’ arising out of it or any part of it.” *Id.* Liberty Mutual argued the duct work was a Building Specialties product and that Exclusion K barred coverage for “property damage” to the duct work itself. *Id.* Building Specialties countered that Exclusion K does not apply to a building or its components. *Id.* (citing *Mid-United Contractors, Inc. v. Providence Lloyds Ins. Co.*, 754 S.W.2d 824, 826 (Tex. App.—Ft. Worth 1988, writ denied); *CU Lloyd's of Tex. v. Main Street Homes, Inc.*, 79 S.W.3d 687, 697 (Tex. App.—Austin 2002, no pet.)). Because Building Specialties did not construct the house at issue, only installing the duct work in the home, Liberty Mutual argued *Mid-United* and *Main Street Homes* did not apply. *Id.* The court agreed with Liberty Mutual, finding the ducts were more similar to components that are manufactured and later installed into a house than to the complete buildings at issue in *Mid-United*. *Id.* at 647. Thus, “[t]o the extent Building Specialties claims a duty to defend or indemnify arising out of ‘property damage’ to the faulty product—the cost of remedying the defective insulation—that claim is precluded by the ‘your product’ exclusion as a matter of law.” *Id.*

2. Exclusion L

Exclusion L states the insurance policy at issue does not cover “[p]roperty damage to ‘your work’ arising out of it or any part of it and included in the ‘products-completed operations hazard.’” *Id.* The court looked to *Wilshire Insurance Co. v. RJT Construction, LLC*, 581 F.3d 222, 226 (5th Cir. 2009), which held the identical exclusion precluded coverage for the cost of repairing the insured's own work. Importantly, the court noted in *Building Specialties* a key difference between the facts before it and the facts in *RJT*: “Lone Star alleged damages only for repairing and replacing Building Specialties’ allegedly defective duct work. . . . The ‘your work’ exclusion applies to all Lone Star’s claims, instead of just a portion of the claims as in *Wilshire Insurance Co.*” *Building Specialties*, 712 F. Supp. 2d at 648.

In response, Building Specialties argued that the subcontractor exception to Exclusion L, which states the exclusion does not apply to work “performed on [the insured’s] behalf by a subcontractor,” applied to reinstate coverage. *Id.* In Building Specialties’ president’s affidavit, he stated that “almost all of the actual fabrication and installation of the insulation material was performed by laborers employed by Marek Employment Management Company (“Memco”).” *Id.* Because the pleadings themselves did not mention Building Specialties’ use of subcontractors, though, under the Supreme Court of Texas’ ruling in *Pine Oak Builders*, Liberty Mutual did not have a duty to defend Building Specialties as a matter of law. *Id.* Turning to the duty to indemnify, the court underwent a significant discussion of how “subcontractor” might be

defined. *Id.* at 648–51. The court concluded the record was insufficient to find as a matter of law whether Memco and Knauf were Building Specialties’ “subcontractors” for purposes of the subcontractor exception to Exclusion L. *Id.* at 651. Thus, the subcontractor exception might have applied to Liberty Mutual’s duty to indemnify Building Specialties. *Id.* Nevertheless, because the court already had found the occurrence at issue did not cause “property damage,” and because exclusion K barred recovery for the damages asserted, coverage was precluded as a matter of law. *Id.*

E. Commentary

The Southern District of Texas’ opinion in *Building Specialties* is a reflection of the continued reliance on *Lamar Homes* and the proper distinction between merely defective work and “property damage” (i.e., “physical injury to tangible property”). It also makes clear that an “occurrence” can be alleged even when magical words (i.e., negligence or accident) are not used by the underlying plaintiffs. Importantly, the court emphasized again that the ownership of the property damaged is not outcome determinative when analyzing whether “property damage” exists. Rather, the court looked to the exclusions in the policy to determine whether any such “property damage” should be covered by the policy. Because the court had ruled that no allegations and no evidence of “property damage” existed, its analysis of Exclusions K and L was unnecessary. Nevertheless, the discussion was important—at least with regard to Exclusion K. The court’s finding that the defective duct work was a product even after it was installed and incorporated into the house could have significant coverage implications in construction defect litigation. This case also highlights the importance of drafting pleadings as Judge Rosenthal declined to look beyond the “eight corners” rule. All in all, this case presents the “ABCs” of an insurance coverage analysis for construction defect claims.

VI. *Essex Insurance Co. v. McFadden*, 2010 WL 2246293 (E.D. Tex. June 3, 2010)

On June 3, 2010, the Eastern District of Texas issued its opinion in *Essex Insurance Co. v. McFadden*, 2010 WL 2246293 (E.D. Tex. June 3, 2010) holding, in part, that the “your work” and “your product” exclusions did not preclude a duty to defend in a negligence case involving a workplace fire.

A. Background Facts

Southland Disposal, Inc. (“Southland”) hired KLN Contractors (“KLN”) to repair a load ramp connected to Southland’s saltwater disposal trough. KLN delegated this assignment to McFadden, the principal owner of KLN. KLN and/or McFadden made welding repairs between deliveries of flammable condensate into a disposal trough. *Id.* at *1. Pointe Coupee was responsible for developing the plan and monitoring the procedure for unloading the trucks, rinsing the trough, and permitting welding. At some point, KLN and/or McFadden allegedly failed to properly wash and rinse the saltwater trough after a delivery. When the welding resumed, sparks ignited causing a fire which resulted in costs of \$116,520.43 to repair. In the underlying suit against McFadden, KLN and Pointe Coupee, Great American Insurance Co. as subrogee of Southland alleged the parties were negligent and were jointly and severally liable. *Id.*

McFadden, KLN and Pointe Coupee all submitted claims to Essex Insurance Co. (“Essex”) for coverage under a commercial liability insurance policy issued to McFadden and/or KLN and naming Pointe Coupee as an additional insured. *Id.* at *2. Essex denied coverage and argued there was no duty to defend the parties. In its motion for summary judgment, Essex asserted six separate arguments as to why no duty to defend existed. Specifically, Essex contended: (1) the “Who Is An Insured” provision limits coverage from an individual to conduct a business for which the insured is the “sole owner”; (2) coverage is restricted to operations under the “business description” or “classification” in the policy declarations; (3) coverage for “professional services” is restricted; (4) exclusions J(4) and J(5) preclude coverage; (5) the “your product” exclusion applied; and (6) the additional insured endorsement provides coverage to Pointe Coupee only as respects the negligent acts or omissions of McFadden. Each of these contentions was considered separately, but briefly, by the court.

B. Essex’s Duty to Defend

1. “Who Is An Insured” and Business Description and Classification

Regarding the “Who Is An Insured” provision, Essex argued that because the Declarations listed the Named Insured—McFadden—as an individual, coverage is limited to “conduct for the business of which the insured is the ‘sole owner.’” *Id.* at *4. In the underlying lawsuit, however, McFadden was alleged to be the “principal owner” of KLN and not the “sole owner.” *Id.* In contrast, Pointe Coupee—the only defendant in the coverage suit to file an answer—agreed that “sole owner” and “principal owner” mean different things, but Pointe Coupee argued one could be the “sole owner” and the “principal owner” or be the “principal owner” and not be the “sole owner.” *Id.* at *5. In other words, the allegation that McFadden was the “principal owner” did not bear on whether he was the “sole owner” of KLN. The court agreed with Pointe Coupee, holding “the allegation that McFadden is the principal owner does not affirmatively establish that he is not the sole owner.” *Id.* Because Pointe Coupee offered a reasonable construction of the words in the provision, summary judgment was precluded on that point. *Id.*

Turning to the business description and classification listed on the policy Declarations, the court explained that the policy provides coverage for “above ground water line installation/service” with a classification for the insured as “water mains or connections construction.” *Id.* Essex argued no indication existed McFadden would face liability for a fire caused by welding a grate in a saltwater disposal pit. *Id.* Moreover, the work described in the underlying lawsuit did not fall within the above descriptions. *Id.* Pointe Coupee countered that the defendants were performing service work on a saltwater disposal trough, which was used to transport saltwater. *Id.* Thus, it was an above ground water connection. Moreover, the words in the policy were not as limited as Essex thought—“water” does not exclude saltwater, “service” and “construction” do not exclude welding repairs, and “water mains” or “water connections” do not exclude water troughs. *Id.* Again, the court agreed Pointe Coupee presented a reasonable construction of the policy and agreed the defendants’ operations fell within the policy’s business description and classification for purposes of the duty to defend. *Id.* at *6.

2. “Professional Services” Exclusion

Essex also argued the “professional services” exclusion in its policy precludes coverage because welding is a professional service. *Id.* Pointe Coupee, on the other hand, argued that professional services is “an act or service ‘arising out of a vocation, calling, occupation, or employment involving specialized knowledge, labor or skill, and the skill is predominately mental or intellectual, rather than physical or manual.’” *Id.* Because “professional services” was not defined in the policy, the court found that “[i]n order to qualify as a professional service, ‘the task must arise out of the acts particular to the individual’s specialized vocation. [The court does]not deem an a professional service merely because it is performed by a professional. Rather, it must be necessary for the professional to use his specialized knowledge or training.’” *Id.* (quoting *Atlantic Lloyd’s Ins. of Tex. v. Susman Godfrey LLP*, 982 S.W.2d 472, 476–77 (Tex. App.—Dallas 1998, pet. denied)). Because Essex did not prove welding was a “professional service,” the court held the professional services exclusion did not preclude a defense duty.

3. Exclusions J(4) and J(5)

The court then turned its attention to Exclusions J(4) and J(5) of the policy. Exclusion J(4) bars coverage for property damage to “personal property in the care, custody or control of the insured” and Exclusion J(5) bars coverage for property damage to “that particular part of real property on which you or any of your contractors or subcontractors . . . are performing operations if the ‘property damage’ arises out of those operations.” *Id.* at *7. Essex argued that because the Defendants were performing welding work on the trough at the time of the fire, the equipment and pieces comprising the saltwater disposal trough were in the care, custody or control of the Defendants. *Id.* The court explained that “a ‘care, custody or control’ exclusion applies only to the ‘particular object of the insured’s work, usually personalty, and to other property which [the insured] totally and physically manipulates.’” *Id.* (quoting *Goswick v. Employers’ Cas. Co.*, 440 S.W.2d 287, 289–90 (Tex. 1969)). Thus, the court agreed with Pointe Coupee that no allegations existed in the underlying complaint that Defendants had the right to exercise dominion or control over the trough, much less the rest of the disposal site (which also was damaged). *Id.* at *8. Additionally, the court found there were no allegations defendants were performing operations on any of the other damaged property. *Id.* Accordingly, Exclusions J(4) and J(5) did not exempt Essex from the duty to defend.

4. Exclusion J(6)

Essex also argued exclusion J(6) exempted them from the duty to defend. J(6) excluded property damage to “that particular part of any property that must be restored, repaired or replaced because ‘your work’ was incorrectly performed on it.” *Id.* at *8. Your work” was defined as “work or operations performed by you or on your behalf; and materials, parts or equipment furnished in connection with such work or operations.” *Id.* Pointe Coupee responded that Essex ignored the “that particular part” language and, because the trough was a self-contained collective unit, which was separate from the other areas that were damaged, the exclusion did not apply to everything else at the disposal site that was damaged. The court agreed, distinguishing *Southwest Tank and Treater Manufacturing Co. v. Mid-Continent Casualty Co.*, 243 F. Supp. 2d 597, 603 (E.D. Tex. 2003), where a tank was a self-contained collective unit and the insured was hired to work on the tank and the damages sought were for

replacement of the tank. *See McFadden*, 2010 WL 2246293, at *8. Because the instant case involved damages to property beyond the trough, the court determined Essex failed to show Exclusion J(6) applied to completely defeat the duty to defend.

5. Exclusion K

In Essex's fifth claim, Essex argued Exclusion K applied, which bars coverage for "property damage to 'your product' arising out of it or any part of it." "Your product" was defined as "any goods or products, other than real property, manufactured, sold, handled, distributed or disposed of by . . . you." *Id.* at *9. Essex claimed the damaged equipment was associated with the trough and, therefore, the defendants damaged goods and/or products it was handling during the welding work. *Id.* Pointe Coupee argued the word "handled" meant "to deal or trade in" because it was used as a verb in conjunction with "manufactured," "sold," and "distributed." *Id.* The court found this definition was reasonable and, therefore, found it must adopt the construction offered by Pointe Coupee. *Id.* Because no allegations existed that the Defendants "dealt or traded in" the trough business, Exclusion K did not apply.

6. Additional Insured Endorsement

Finally, the court addressed Essex's claim that coverage did not exist for Pointe Coupee because the Additional Insured Endorsement limited coverage to claims not otherwise excluded by the policy and where coverage is provided to the Named Insured. *Id.* Essex claimed coverage did not exist because no coverage existed for McFadden and KLN under the arguments discussed above. Because the court rejected those arguments already and found a duty to defend existed for McFadden and KLN, the court found Essex also owed a defense duty to Pointe Coupee as an additional insured. Likewise, because the court rejected Essex's arguments regarding the duty to defend, the court found Essex's duty extended to the cross-claims made by Pointe Coupee against KLN and McFadden. The court, rejecting all of Essex's arguments, found Essex had a duty to defend all three insureds in the underlying action and, therefore, denied Essex's motion for summary judgment.

C. Commentary

McFadden is yet another Texas case addressing the scope of the exclusions in a CGL policy that shape the existence of insurance coverage for insureds. Interestingly, the court ruled the insurer owed a defense to all three insureds even though two of the three insureds never responded to the declaratory judgment action filed by Essex. In any event, the more important portion of the court's decision is its focus on the exclusions. The court emphasized the limitations embodied in each exclusion and, when a reasonable interpretation of those exclusions was offered by the insured, the court adopted that interpretation. In sum, the court found a duty to defend existed because the exclusions raised by the insurer did not operate to bar all coverage for the damages asserted, as damage existed to portions of the job site that were not worked on by the insured.

VII. *Gilbert Texas Construction, L.P. v. Underwriters at Lloyd's London*, 2010 WL 2219645 (Tex. June 4, 2010), *reh'g motion filed*

On June 4, 2010, the Supreme Court of Texas issued a much-anticipated opinion addressing the standard form “contractually assumed liability” exclusion of the commercial general liability insurance policy. *See Gilbert Tex. Constr., L.P. v. Underwriters at Lloyd's London*, 2010 WL 2219645 (Tex. June 4, 2010). The opinion can be read in two ways: Either it can be read in a manner limiting it to the particular facts before the Court or it can be read—and likely will be read by insurers—as a sweeping opinion negating all coverage for breach of contract claims. The better reasoned reading, however, is the former, as the Court seemingly did not intend to negate coverage in such a broad manner. Notably, we previously addressed the court of appeals’ decision in this case in Volume 2, Issue 7 of the *Insurance Law Newsletter* (available at <http://www.vsfirm.com/publications>). The court of appeals’ decision is published at *Underwriters at Lloyd's of London v. Gilbert Texas Construction, L.P.*, 245 S.W.3d 29 (Tex. App.—Dallas 2007, pet. granted), *aff'd* 2010 WL 22196456 (Tex. June 4, 2010), *reh'g motion filed*.

A. Background Facts

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

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

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

Gilbert’s primary insurer, Argonaut Insurance Company, defended Gilbert in the litigation. Its excess insurer, Underwriters at Lloyd’s of London (“Underwriters”), issued several reservation of rights letters outlining its position as to indemnity coverage for the RTR lawsuit. In particular, with regard to the breach of contract claim, Underwriters questioned whether a breach of contract constituted an “occurrence” as that term is defined under the Underwriters’ policies. During the underlying litigation, and while maintaining the position that a breach of

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

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

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

B. The Declaratory Judgment Action

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

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

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

at 34. The court of appeals found that the exclusion applied on its face because the claims against Gilbert in the underlying action “were based on Gilbert’s assumption of liability in its contract with DART to repair property damage to third-party property.” *Id.*

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

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

Id. at 34–35.

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

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

As an alternative argument, Gilbert asked the appellate court to preclude Underwriters from denying coverage under the doctrines of waiver and estoppel. *Id.* While normally such doctrines cannot be used to create coverage, an exception exists (or existed at the time of the

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

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

C. Petition for Review to the Supreme Court of Texas and the Court’s Opinion

Gilbert filed a petition for review with the Supreme Court of Texas on April 2, 2008. It raised three issues for the Court to address: (i) the appellate court erred in applying the “contractually assumed liability” exclusion to negate coverage; (ii) even if the appellate court correctly concluded the exclusion applied, it erred when it failed to apply the express exception for liability the insured would have in the absence of the contract or agreement; and (iii) the appellate court erred in concluding Underwriters had not waived and/or was not estopped from raising coverage defenses. The Court ultimately requested full briefing and oral argument was held on October 6, 2009. On June 4, 2010, the Court issued its opinion, disagreeing with Gilbert on all three issues.³

1. Jurisdiction

At the outset, the Court noted Underwriters’ claim that jurisdiction did not exist was in error. Rather, the Court agreed with Gilbert that the Dallas Court of Appeals’ decision conflicted with a decision from the Fourteenth Court of Appeals in Houston, which held that the contractually assumed liability exclusion is limited to liability assumed for conduct of a third party, such as an indemnity or hold-harmless agreement. *Gilbert*, 2010 WL 2219645 at *3 (citing *Lennar Corp. v. Great Am. Ins. Co.*, 200 S.W.3d 651, 693 (Tex. App.—Houston [14th Dist.]

³ In the interest of full disclosure, Visser Shidlofsky LLP was co-counsel for Gilbert Texas Construction for the appeal to the Supreme Court of Texas.

2006, pet. denied)). Accordingly, the Court had jurisdiction pursuant to Section 22.001(a)(2) of the Government Code.

2. The Contractually Assumed Liability Exclusion

Turning to the primary issue, the Court noted Underwriters did not dispute that Gilbert's claim fell within the general terms of the insurance policy, but argued that the contractually assumed liability exclusion barred coverage. *Id.* at *4. Underwriters reasoned that at the time of Gilbert's settlement with RTR, the only basis for liability remaining in the lawsuit was for the breach of contractual obligations Gilbert assumed in its contract with DART. Underwriters also argued Gilbert waived its argument regarding the inapplicability of the exclusion. On that particular issue, the Court disagreed with Underwriters. "While ordinarily a party waives a complaint not raised in the court of appeals, a complaint arising from the court of appeals' judgment may be raised in a motion for rehearing in that court or in a petition for review in this Court." *Id.* (citing Tex. R. App. P. 53.2(f); *Bunton v. Bentley*, 153 S.W.3d 50, 53 (Tex. 2004)).

After explaining how Texas courts follow bedrock principles regarding the interpretation of insurance policies, the Court looked specifically to the scope of the contractually assumed liability exclusion. The Court said:

Considered as a whole, the contractual liability exclusion and its two exceptions provide that the policy does not apply to bodily injury or property damage for which the insured is obligated to pay damages by reason of the assumption of liability in a contract or agreement, except for enumerated, specific types of contracts called "insured contracts" and except for instances in which the insured would have liability apart from the contract.

Id. at *5. According to the Court, Gilbert agreed in its contract to "repair any damage to . . . facilities, including those that are the property of a third party, resulting from failure to comply with the requirements of this contract or failure to exercise reasonable care in performing the work." *Id.* Because the tort theories of liability had been eliminated by summary judgment, the Court found that the only remaining theory of liability arose from that undertaking in its contract—"an obligation Gilbert assumed by contract." *Id.*

The Court rejected Gilbert's reliance on *American Family Mutual Insurance Co. v. American Girl, Inc.*, 673 N.W.2d 65, 80–81 (Wis. 2004)—and numerous cases like it—that held that to give meaning to the word "assumption" in the exclusion, the liability assumed must be that of *another*. *Id.* at *6. Gilbert urged the Court to recognize that the contractually assumed liability exclusion requires a three-party transaction. That is, the exclusion may have applied had Gilbert assumed DART's liability to RTR. Because Gilbert was being sued directly for *its* liability to RTR, however, the exclusion should not have applied. And, for this same reason, even if the exclusion applied, the "insured contract" exception never would have applied under the facts in *Gilbert* because of the lack of a third party. Nevertheless, the Court agreed with Underwriters that such reading requires insertion of words into the parties' contract that do not exist. "The parties' intent is governed by what they said in the insurance contract, not by what one side or the other alleges they intended to say but did not." *Id.* (citing *Fortis Benefits v. Cantu*, 234 S.W.3d 642, 647, 649 (Tex. 2007)). Accordingly, the Court recognized that if the parties had

intended the contractually assumed liability exclusion only to apply to indemnity and hold-harmless agreements, the parties would have stated such.

Moreover, under the generally accepted meaning of the words, “assume” means to “undertake.” The Court explained:

Independent of its contractual obligations, Gilbert owed RTR the duty to comply with law and to conduct its operations with ordinary care so as not to damage RTR's property, and absent its immunity it could be liable for damages it caused by breaching its duty. In its contract with DART, however, Gilbert undertook a legal obligation to protect improvements and utilities on property adjacent to the construction site, and to repair or pay for damage to any such property “resulting from a failure to comply with the requirements of this contract *or* failure to exercise reasonable care in performing the work.” (emphasis added). The latter obligation—to exercise reasonable care in performing its work—mirrors Gilbert's duty to RTR under general law principles. *The obligation to repair or pay for damage to RTR's property “resulting from a failure to comply with the requirements of this contract” extends beyond Gilbert's obligations under general law and incorporates contractual standards to which Gilbert obligated itself.*

Id. (emphasis added). As such, and because all the other theories of tort liability were dismissed, the only remaining claim “was founded on an obligation or liability contractually assumed by Gilbert within the meaning of the policy exclusion.” *Id.*

The Court further explained that even the exceptions to the exclusion support its holding. In particular, the “insured contract” exception to the exclusion explicitly addresses assumption of the tort liability *of another*. Thus, the Court said, the use of that language in the policy shows “the parties are capable of using such narrow, specific language when that is their intent.” *Id.* at *7. The Court rejected Gilbert’s position that the exclusion should apply to situations in which the insured assumes the liability of another and the exception to the exclusion as applying only to the insured’s assumption of the tort liability of another. *Id.* Rather, the Court found the language of the exclusion applies “without qualification” to the contractual assumption of liability with only two exceptions: insured contracts and situations in which the insured’s liability does not depend solely on obligations assumed in the contract. *Id.* Further, the Court rejected Gilbert’s argument that the contractually assumed liability exclusion cannot be read as a breach of contract exclusion because Coverage B includes a pure breach of contract exclusion, as well as a contractually assumed liability exclusion. The Court was not persuaded, finding the contractually assumed liability exclusion in Coverage A “means what it says:”

[I]t excludes claims when the insured assumes liability for damages in a contract or agreement, except when the contract is an insured contract or when the insured would be liable absent the contract or agreement. The express breach of contract exclusion in Coverage B, on the other hand, excludes all claims “arising out of” a breach of contract—a potentially larger category of claims than is excluded under the contractual liability exclusion.

Id. at *8. Similarly, the Court—in a footnote—dismissed Gilbert’s argument that the inclusion of an express breach of contract exclusion in some policies is further support that the contractually assumed liability exclusion is not intended to exclude general breach of contract claims. *See id.* at *8 n.7. The Court said: We are not persuaded by the argument because the policy we are interpreting does not include such language in Coverage A, and each policy must be interpreted according to its own specific provisions and coverages.” *Id.*⁴

The Court also was not persuaded by the vast amount of case law cited by Gilbert from other jurisdictions—including the 5th Circuit—which apply the exclusion to a limited category of cases when the insured assumes the liability of another. *Id.* In fact, despite noting twelve cases and treatises favoring Gilbert’s interpretation, the Court sided with Underwriters and a mere five cases supporting its interpretation. In rejecting what clearly is the majority rule, the Court specifically noted that the Alaska Supreme Court’s decision in *Olympic, Inc. v. Providence Washington Insurance Co. of Alaska*, 648 P.2d 1008 (Alaska 1982), interpreted an earlier version of the CGL form that referred to “incidental contracts” instead of “insured contracts,” and “incidental contracts” did not include indemnity or hold-harmless agreements. *Id.* at *8–*9. Thus, “[t]he court was not faced with a circular reading of the exclusion and insured-contract exception as we are in the instant dispute.” *Id.* at *9. Moreover, the Court disagreed with those courts’ and treatises’ conclusions in Gilbert’s favor because Texas courts adhere to the plain language of insurance contracts in determining its intended coverage. So, it applies when an insured assumes liability for bodily injury or property damage through a contract unless an exception applies. *Id.* at *10.

Continuing, the Court also did not agree with Gilbert’s argument that adoption of Underwriters’ interpretation “effectively eviscerates” the Court’s decision in *Lamar Homes*. In distinguishing that case, the Court noted it was addressing Underwriters’ duty to indemnify Gilbert and that only the duty to defend was at issue in *Lamar Homes*. In making its distinction, the Court interestingly noted that in *Lamar Homes* it stated: “‘the label attached to the cause of action—whether it be tort, contract, or warranty does not determine the duty to defend’ and that ‘any preconceived notion that a CGL policy is only for tort liability must yield to the policy’s actual language.’” *Id.* (quoting *Lamar Homes*, 242 S.W.3d at 13). Despite that quote, which extends beyond the duty to defend, the Court ultimately held in *Gilbert* that the label on the cause of action does, in fact, matter, as the contractual liability exclusion bars recovery if the only theory of liability remaining against an insured is a breach of contract claim. Put simply, even though the Court found that “[w]hether a claim triggers an insurer’s duty to defend and whether a claim eventually is covered or excluded for purposes of indemnity are different questions,” its opinion does not hold true to that claim.⁵ *See id.* Rather, the Court’s opinion seemingly concludes that the cause of action *does* govern whether a claim is “covered.”

⁴ Underwriters’ policy had a “failure to perform” exclusion, which Underwriters contended also negated coverage. If the contractually assumed liability exclusion is a breach of contract exclusion, one must wonder why Underwriters also needed a “failure to perform” exclusion in its policy.

⁵ If *Lamar Homes* was only a duty to defend case, one also has to wonder why the Supreme Court of Texas denied the petition for review in *Lennar Corp. v. Great American Insurance Co.*, 200 S.W.3d 651 (Tex. App.—Houston [14th Dist.] 2006, pet. denied), which involved the duty to indemnify and was based on the same reasoning as *Lamar Homes*.

For example, consider the case of *Lamar Homes*: There, the Court found that “property damage” clearly existed and that such damage was caused by an “occurrence.” Moreover, the damage fell within the subcontractor exception to exclusion *l*. In other words, the facts of the case fit the mold for the classic completed operations coverage under a standard CGL policy. But, had defense counsel for Lamar Homes moved for summary judgment on the economic-loss rule and succeeded, leaving only a claim against Lamar Homes based in contract, is the Court now saying coverage would not exist based on the contractually assumed liability exclusion? Similarly, consider the same facts but that the homeowner waited three years after discovering the “property damage” at issue before filing its tort and breach of contract claims. Again, through summary judgment defense counsel could succeed at having the tort claims dismissed based on a statute of limitations defense, leaving only a claim based in contract. Under the Court’s opinion in *Gilbert*, is the “property damage” caused by an “occurrence” that falls within the subcontractor exception to exclusion *l* now not covered simply because the only viable theory of liability is one based in contract?

If the foregoing scenarios result in a finding of no coverage under *Gilbert*, then the Court’s opinion is unprecedented in holding that the label of the cause of action controls coverage. Regardless whether a court addresses the duty to defend or the duty to indemnify, coverage should not ride on the cause of action supporting it (except perhaps in the context of intentional torts). And, while the Court may not have intended for its decision to have such ramifications, the reality of the situation is that its opinion certainly can be—and is being—interpreted in that way by *some* carriers.

3. The Second Exception to the Contractual Liability Exclusion

As previously noted, the second exception to the contractually assumed liability exclusion states the exclusion “does not apply to liability for damages . . . [t]hat the insured would have in the absence of the contract or agreement.” *Id.* *Gilbert* argued it would have had liability in the absence of the contract because without the contract it would not have had governmental immunity. *Id.* That is, it would have been liable in tort to RTR but for its contract with DART. Underwriters, on the other hand, contended the duty to indemnify is based on the “actual facts,” and the actual facts at the time of *Gilbert*’s settlement was that the only remaining theory of liability was breach of contract. Again, the Court agreed with Underwriters.

After citing case law supporting its position that indemnity is based on actual adjudicated facts, the Court explained the second exception modifies the exclusion such that an insurer does not have to indemnify the insured if the insured is obligated to pay only because of its contractually assumed liability. “If the insured’s liability is because of an otherwise covered basis in addition to its contractually-assumed liability [i.e., a differently labeled cause of action], the second exception brings the claim back into coverage.” *Id.* at *12. Thus, the Court had to determine whether *Gilbert* proved it would have had liability for RTR’s damages in the absence of its contract with DART.

Again, *Gilbert* contended it would have had liability in tort if the contract did not exist because it would not have been entitled to governmental immunity. The Court, however, claimed that *Gilbert*’s argument “misses the mark,” reasoning that “[t]he determination of an indemnity obligation is based on the actual facts of the case as proven and the language of the indemnity

agreement.” *Id.* Accordingly, the existence of the contract was an “underlying fact” to consider in determining Underwriters’ obligations. Because Gilbert asserted no other basis for its settlement other than RTR’s breach of contract action, “Gilbert’s settlement payment for which it seeks indemnity simply was not a liability for damages it had apart from its contract with DART, as it must have been in order for the second exception to apply.” And, although Texas courts construe exceptions to exclusions broadly in favor of coverage, the Court found Gilbert’s argument distorted the exclusion and required the Court to ignore the underlying facts. *Id.* at *13. In other words, the Court believed Gilbert argued that the Court should “hold that the exception applies even to potential liability that Gilbert *might* have had if it had not entered into a contract with DART.” *Id.* The Court refused to do so.

With all due respect to the Court, Gilbert did not disagree that underlying facts supporting the settlement must be considered in determining Underwriters’ indemnity obligation, but the “plain language” of the policy specifically requires a fact-finder to consider the scenario “in the *absence* of the contract.” To do that, one necessarily must consider a “fact” different than the underlying facts, and, as the Court noted previously in its opinion, “[t]he parties’ intent is governed by what they said in the insurance contract, not by what one side or the other alleges they intended to say but did not.” *Id.* at *6. Put simply, the parties clearly intended by the plain language of the policy to disregard the contract at issue and determine whether liability otherwise would have existed. Because it would have—as Gilbert would not have enjoyed immunity from tort claims without the contract—coverage should have existed under the exception to the exclusion.

The Court also rejected Gilbert’s argument that the Court’s reading of the exclusion will bar coverage anytime a tort claim is dismissed during litigation and all that remains is a contract claim. By way of example, Gilbert argued that the exclusion would now bar coverage if a tort claim is dismissed based on a statute of limitations defense leaving only a breach of contract claim. Although acknowledging Gilbert’s concern regarding such situations, the Court said: “speculation about coverage of insurance policies based on surmised factual scenarios is a risky business because small alterations in the facts can warrant completely different conclusions as to coverage. It is proper that we await a fully developed, actual case to decide an issue not presented here.” *Id.* at *13. This statement is perhaps the best signal that the Court did not intend for its holding to apply broadly to all breach of contract claims.

Nevertheless, while it certainly is understandable that the Court would not want to speculate about hypotheticals, the potential broad stroke of its opinion creates the need to consider such speculative situations. More specifically, because the Court did not specifically limit its opinion to the facts before it, application of the exclusion in the statute-of-limitations scenario discussed above is a real possibility. Additionally, as noted, a similar scenario could arise when a tort claim is dismissed because of the economic-loss rule, leaving only a breach of contract claim. Again, just as argued by Gilbert before the Court, such a scenario would enable a carrier to deny coverage for what would otherwise be a covered claim simply because the cause of action pertains to liability based in contract rather than tort. That very result is one the Court seemingly rejected in *Lamar Homes* in which the Court said: “Therefore, any preconceived notion that a CGL policy is only for tort liability must yield to the policy’s actual language.” *Id.* at *13. As such, despite the unique facts of *Gilbert*, the Court’s holding potentially does in fact have broad implications. And, while it may not have overruled *Lamar Homes*, application of

Gilbert to eliminate coverage for breach of contract claims certainly would gut the holding of *Lamar Homes*.

4. Estoppel

Finally, the Court also rejected Gilbert's third position—that Underwriters was estopped to deny coverage because Underwriters assumed control of Gilbert's defense and, in doing so, prejudiced Gilbert. Notably, the Court disagreed with Underwriters that Gilbert had waived its estoppel argument. Gilbert had made a similar argument in the court of appeals, but after that court issued its decision, the Supreme Court of Texas overruled the line of cases on which Gilbert relied when it issued its opinion in *Ulico Casualty Co. v. Allied Pilots Association*, 262 S.W.3d 773, 782 (Tex. 2008). As such, before the Court, Gilbert reframed its argument to comport with the *Ulico* holding. The Court found that because of the unusual circumstances of the case, and because an analysis under *Ulico* essentially is the same as that undertaken by the court of appeals, Gilbert was entitled to make its estoppel argument.

To support its contention, Gilbert asserted that Underwriters failed to reserve its rights with regard to the contractually assumed liability exclusion and then urged Gilbert's defense counsel to move for summary judgment on governmental immunity even though Underwriters knew it intended to deny coverage under the exclusion if the summary judgment was successful. Moreover, Underwriters would not agree that mediation was proper until after the summary judgment issue was decided. Gilbert's defense counsel even testified that he had been pressured by Underwriters and feared Underwriters would invoke the cooperation clause in its policy if he did not comply. Further, Gilbert argued it was prejudiced by those actions because Underwriters dangled the cooperation clause knowing it would deny coverage if the summary judgment was successful. Nevertheless, the Court agreed with the court of appeals that Underwriters did not control Gilbert's defense and, even if it did control the defense, Gilbert was not prejudiced. *Gilbert*, 2010 WL 2219645 at *14.

With regard to the cooperation clause issue, the Court said Underwriters' alleged threat "does not rise to the level of actually assuming control of Gilbert's defense." *Id.* at *15. Rather, Underwriters' excess policy did not have a duty to defend provision but provided Underwriters the right to associate with Gilbert's defense. Moreover, the Court found Underwriters had the right to stand on its cooperation clause. Gilbert had its own separate defense counsel and had the right to refuse to assert its governmental immunity defense and litigate its case or settle RTR's claim. In either instance, Gilbert could later seek recovery of an excess judgment or settlement from Underwriters. "Underwriters' disclosure of its intent to stand on contractual rights in its policy does not equate with asserting actual control over Gilbert's defense." *Id.*

Further, the Court explained that while Underwriters did not specifically reserve its rights under the contractually assumed liability exclusion, it made clear that the breach of contract claim potentially was not covered and, therefore, a potential conflict existed between Gilbert and its insurer. As such, Underwriters' internal communications regarding the lack of coverage for the breach of contract claim was no different than what was communicated to Gilbert in Underwriters' reservation of rights letters. Moreover, Gilbert's defense counsel testified that he raised the governmental immunity defense in Gilbert's original answer—before ever being in

contact with Underwriters or its counsel. Thus, the issue was raised “without any prompting from Underwriters.” *Id.*

The Court, having found that Gilbert’s estoppel argument lacked merit, then went a step further, finding that *even if* Underwriters assumed control of Gilbert’s defense, Gilbert was not prejudiced by such action. The Court rejected Gilbert’s reliance on *Employers Casualty Co. v. Tilley*, 496 S.W.2d 552 (Tex. 1973), finding the facts of the two cases were not similar. In particular, Underwriters had no duty to defend Gilbert and did not appoint Gilbert’s defense counsel, as was the case in *Tilley*. And, Gilbert’s defense counsel did not defend Gilbert while also representing Underwriters as coverage counsel. Also, Underwriters acted within its rights in associating in Gilbert’s defense and, at the same time, noting to Gilbert that if a valid defense was not presented the cooperation clause may be implicated. Finally, unlike in *Tilley*, Underwriters issued reservation of rights letters putting Gilbert on notice of a potential conflict between them. *Id.* at *16. Thus, the Court held that “the court of appeals did not err in determining there was not a fact issue as to Gilbert’s estoppel claim.” *Id.*

The estoppel holding by the Court also has the potential for broad implications in the field of insurance coverage. Arguably an insurer—primary or excess—can direct defense counsel to move for summary judgment on a tort defense even if doing so will force the insured into being left with only a contractual claim against it. That is, the insurer can direct the insured to a dismissal of a tort claim, leaving only a breach of contract claim that may fall within the contractually assumed liability exclusion. Such a situation has the effect, if *Gilbert* is construed broadly, to turn a covered claim for “property damage” caused by an “occurrence” into an uncovered claim. Thus, the combination of the Court’s ruling on the cooperation clause issue and its interpretation of the contractually assumed liability exclusion potentially is disastrous.

D. Commentary⁶

The facts of *Gilbert* and the Court’s broad holdings already are sending shockwaves through the insurance coverage community. As a means to stop the ripple effect, Gilbert filed a motion for rehearing and amicus curiae support quickly is building. It seems apparent that, although the Court acknowledged it was taking the minority position, it did not fully appreciate the potential and perhaps unintended ramifications of its holdings. Accordingly, even if the Court does not reverse its 9-0 decision, it may take the opportunity to limit its holdings to the particular facts of Gilbert, specifying—perhaps—that the governmental immunity defense is a special one that is not on par with a statute of limitations or economic-loss rule defense. Put simply, this author does not believe the Court truly meant to hold that the contractually assumed liability exclusion is a pure “breach of contract” exclusion. Nevertheless, that is how the Court’s opinion is being interpreted by some carriers. As such, if the Court does not clarify its holdings, insurance coverage for insureds who operate through contractual undertakings may be significantly undermined. In addition, its holding with respect to the estoppel argument has potential ripple effects as to what lengths an insurer can go to eliminate covered claims from an

⁶ You may have noticed that, unlike the other cases discussed, the prior sections related to *Gilbert* were argumentative, which begs the question of why a separate “commentary” section is needed. Let’s just say, we are a bit bitter.

underlying lawsuit. To date, the Motion for Rehearing remains pending. Keep your fingers crossed.

VIII. *American Home Assurance Co. v. Cat Tech, LLC*, 2010 WL 2331395 (S.D. Tex. June 9, 2010)

On June 9, 2010, the Southern District of Texas considered the application of the “your product” and “your work” exclusions in a case involving damage to a refinery reactor allegedly caused by an insured. In *American Home Assurance Co. v. Cat Tech, LLC*, 2010 WL 2331395 (S.D. Tex. June 9, 2010), the court determined the two insurance companies at issue were not obligated to cover the insured’s arbitration award because, while the “your product” exclusion did not extend to products merely touched by the insured, the damage was encompassed within the “your work” exclusion. In reaching its decision, the court looked to the proper definition of “handle.” It also applied the important distinction in *Wilshire Insurance Co. v. RJT Construction, LLC*, 581 F.3d 222, 226 (5th Cir. 2009), between damage that *arose out of* the insured’s work and damage *to* the insured’s work.

A. Background Facts

In 2005, Ergon Refining, Inc (“Ergon”) hired Cat Tech, LLC (“Cat Tech”) to service a reactor at their refinery. Subsequently there were two events which caused damage to the reactor. *Id.* at *2. The parties went to arbitration and the arbitrators made the following findings: First, the arbitrators found Cat Tech failed to properly place rope packing around a bed screen, which caused damage to the bed reactor internals, migration of catalyst from Bed 3 to Bed 4, and damage to some of the catalyst. *Id.* Second, the arbitrators determined a subsequent accident was caused by an excessive pressure drop in Bed 3. The arbitrators found Cat Tech was solely in control of screening and loading the catalyst, and found Cat Tech responsible for the damage. *Id.* at *3. Ergon was awarded total damages of \$1,973,180.00. *Id.* at *4.

The insurance case arose out of a dispute between Cat Tech, their CGL insurer American Home Assurance Co. (“American Home”), and their umbrella insurer National Union Fire Insurance Co. of Pittsburgh, Pa. (“National Union”). American Home paid Cat Tech \$1 million, the per occurrence policy limit, subject to a reservation of rights and then filed this suit seeking a declaratory judgment that they had no duty to indemnify Cat Tech. Cat Tech counterclaimed for a declaratory judgment that they were entitled to indemnity for the total arbitration award. *Id.* at *6.

American Home’s CGL policy provided up to \$1 million of coverage per occurrence and up to \$2 million total coverage. The National Union umbrella policy provided coverage up to \$10 million per occurrence upon exhaustion of the primary insurance. The terms in the policies were similar, so the court considered them together. The insurers argued the “your product” and “your work” exclusions barred coverage for the arbitration award. The policy did not apply to:

k. Damage to Your Product

“Property damage” to “your product” arising out of it or any part of it.

1. 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.”

Id. at *5. “Your product” was defined as “any goods or products, other than real property, manufactured, sold, handled, distributed, or disposed of by . . . (a) You. *Id.* “Your work” was defined as “work or operations performed by you or on your behalf” and “materials, parts or equipment furnished in connection with such work or operations” including warranties or representations about “your work.” *Id.* at *6.

B. “Handle” Defined and “Your Product”

The court first recognized there was “no evidence in the record that Cat Tech manufactured, sold, distributed, or disposed of any products, goods, or materials it used to service the Ergon reactor or that were damaged.” *Id.* at *12. Nevertheless, the insurers argued the “your product” exclusion applied to the “rendition of services and the materials handled while the services was being rendered.” *Id.* In support of this argument, the insurers relied primarily on *United States Fire Insurance Co. v. Massey Irrigation & Liquidation, Inc.*, 40 F.3d 385, 1994 WL 652250 (5th Cir. 1994). There, the Fifth Circuit rejected the insured’s argument that “providing services, such as repairs, does not constitute a defective product and thus does not fall within the ‘products-completed operations hazard’ exclusion.” *Id.* at *12 (citing *Massey*, 1994 WL 652250, at *2). *Massey* relied on the decisions in *Green v. Aetna Insurance Co.*, 349 F.2d 919 (5th Cir. 1965), and *Pan American Insurance Co. v. Cooper Butane Co.*, 300 S.W.2d 651 (Tex. 1957), in concluding that “under Texas law the completed operations hazard includes rendition of services.” *Cat Tech*, 2010 WL 2331395, at *12 (citing *Massey*, 1994 WL 652250, at *3). The *Cat Tech* court, however, concluded *Massey*’s conclusion was “not the same as holding that the ‘your product’ exclusion covers the insured’s rendition of services.” *Id.* at *13. This was in part, the court noted, because the *Massey* court did not address the “your product” exclusion specifically.

The insurers additionally argued Cat Tech “handled” Ergon’s damaged goods or products when they performed the work. The court looked to the Fifth Circuit which has held the “verb ‘handled’ as used in [the ‘your product’] exclusion . . . means ‘to deal or trade in rather than ‘to touch.’” *Id.* (quoting *Todd Shipyards Corp. v. Turbine Service, Inc.*, 674 F.2d 401, 420 (5th Cir. 1983)). The *Todd* court further explained, “[T]he intention of the insurer was to restrict the word ‘handled’ to this meaning is apparent from the words ‘manufactured, sold or distributed.’” *Id.* (quoting *Todd Shipyards*, 674 F.2d at 420). The *Cat Tech* court concluded the Fifth Circuit definition precluded the insurer’s proposed definition of “your product,” and, because no evidence existed that Cat Tech bought, sold, dealt, traded in, or supplied any of the materials they used in their work on the reactor, the “your product” exclusion did not apply. *Id.* at *14.

C. “Your Work” Exclusion

Turning to the insurers’ reliance on the “your work” exclusion, the court noted the policy defined “products-completed operations hazard” as “all property damage occurring away from premises you own or rent and arising out of ‘your product’ or ‘your work.’” *Id.* at *14. “Work”

was “deemed completed at the earliest of . . . when all of the work called for in your contract had been completed,” and “work that may need service, maintenance, correction, repair or replacement, but which is otherwise complete, will be treated as complete.” *Id.* Here, the parties agreed the damage to the Ergon reactor arose out of Cat Tech’s “work,” but disputed “whether the damage was *to* Cat Tech’s work, as the exclusion requires.” *Id.* In its analysis, the court looked to *Wilshire Insurance Co. v. RJT Construction, LLC*, 581 F.3d 222, 226 (5th Cir. 2009), which examined an identical exclusion in its holding. *Wilshire* found “the ‘your work’ exclusion precluded coverage for damage to the parts of a house the insured worked on, but did not preclude coverage for damage to other parts of the house the insured did not work on, even if those other parts were damaged as a result of the insured’s faulty work.” *Cat Tech*, 2010 WL 2331395, at *15. Essentially, in *Wilshire*, the damage to the walls and ceilings fell under the products-competed operations hazard because it *arose out of* the insured’s work, but it did not fall under the ‘your work’ exclusion because it was not damage *to* the insured’s work.” *Id.* (citing *RJT Construction*, 581 F.3d at 226–27). The *Cat Tech* court made an important distinction between *Wilshire* and the present case, acknowledging no distinction existed in the arbitration documents between the parts of the structure the insured worked on and the parts of the structure that were damaged as a result of the insured’s work. *Id.* Put simply, the parts of the reactor Cat Tech worked on were the parts that were damaged, and no indication existed of damage to other parts of the reactor Cat Tech did not work on. *Id.* at *16. Thus, the court found the “your work” exclusion precluded coverage under the insurance policies. *Id.* As such, the court granted the insurers’ motion for summary judgment and found they did not have a duty to indemnify Cat Tech for the arbitration award.

D. Commentary

In *Cat Tech*, a Texas court again had the opportunity to discuss the scope of the “your product” and “your work” exclusions. Again, the court emphasized the important limitations embodied in each exclusion. In particular, because “handled” is used in conjunction with words like “sold” and “distributed,” it is not enough that the insured touched products made by others. Rather, the insured itself must deal in such products for the exclusion to be applicable. This holding on the “your product” exclusion can be contrasted with *Building Specialties*. In *Building Specialties*, Judge Rosenthal was dealing with the insured’s actual “product.” Here, on the other hand, it is the more typical situation where an insured just performs work on a product. The “your product” exclusion is not intended to apply when an insured merely works on a product. Turning to the “your work” exclusion, the court again properly recognized that—for coverage to exist—there must be damage beyond the scope of the insured’s work.

IX. *Westchester Surplus Lines Insurance Co. v. Maverick Tube Corp.*, 2010 WL 2635623 (S.D. Tex. June 28, 2010)

On June 28, 2010, the Southern District of Texas issued its opinion in *Westchester Surplus Lines Insurance Co. v. Maverick Tube Corp.*, 2010 WL 2635623 (S.D. Tex. June 28, 2010), holding that a manufacturing defect which resulted in four different accidents still was only one occurrence under Texas and Missouri law.

A. Background Facts

In July and August of 2006, Maverick Tube Corporation (“Maverick”) sold at least 1,306 pieces of a specific type of casing to its distributor to be shipped to Dominion Exploration and Production Company (“Dominion”) for use in its gas wells. *Id.* at *2. During a two-week period, Dominion experienced failures in four different gas wells that incorporated the casings. *Id.* It was later discovered the casings failed because of a manufacturing defect at Maverick’s processing facility in Columbia. *Id.* Dominion’s original demand was for \$9,802,506.00, and Maverick settled with Dominion in March of 2007 for \$6,601,035.39. *Id.* Westchester Surplus Lines Insurance (“Westchester”), Maverick’s insurer, originally argued Dominion appeared to have a valid breach of contract and warranty claim against Maverick, but no valid negligence claim. *Id.* at *3. It, therefore, denied coverage on the basis that no occurrence existed under the policy. *Id.*

Westchester sued Maverick, seeking a declaratory judgment that the CGL and umbrella policy it issued did not cover Maverick’s settlement of a breach of warranty claim asserted by Dominion. Maverick also moved for summary judgment seeking coverage. *Id.* In its initial consideration of the case, the district court held the policies did not cover the claim because the casing failure was not an “occurrence.” *Id.* Maverick appealed and the Fifth Circuit reversed, remanding the case for a determination of damages. *See Westchester Surplus Lines Ins. Co. v. Maverick Tube Corp.*, 590 F.3d 316 (5th Cir. 2009). The parties agreed Missouri law applied and also that Missouri law was consistent with Texas law which served as a useful supplement to the relatively few Missouri cases on the subject of multiple occurrences. *Id.*

B. Manufacturing Multiple Defects is a Single Occurrence

Before beginning its analysis, the court ruled Westchester had not waived or forfeited the argument that there were multiple occurrences. *Id.* The primary policy defined “occurrence” as “an accident including continuous or repeated exposure to substantially the same general harmful conditions.” *Maverick*, 2010 WL 2635623 at *2. Only two Missouri cases⁷ were identified by the parties on the subject, which the court noted were “not particularly useful to analyzing the present facts of the case.” *Id.* at *6. Instead, the court turned to *National Union Fire Co. of Pittsburgh v. Puget Plastics Corp.*, 649 F. Supp. 2d 613 (S.D. Tex. 2009) for guidance. The court found causation was the key element in analyzing whether there were multiple occurrences. As *Puget Plastics* also was a case involving a manufacturing defect, its application was right on point. In *Puget Plastics*, the insured manufactured defective plastic water chambers that were incorporated into hot water heaters. During the coverage period, approximately 800 chambers failed. The *Puget Plastics* court recognized “a single occurrence may result in multiple injuries to multiple parties over a period of time.” *Id.* (citing *H.E. Butt Grocery Co. v. Nat’l Union Fire Ins. Co.*, 150 F.3d 526, 534 (5th Cir. 1998)). Thus, the court in that case concluded, “Puget Plastics’ failure to mold the water chambers properly was a single occurrence because it was the most intuitively plausible cause of Puget’s liability.” *Id.* at 628 (internal citations omitted).

The *Maverick* court recognized the similarity between these two cases and concluded that, like *Puget Plastics*, the property damage arose out of a single manufacturing defect.

⁷ See *Kansas Fire & Cas. Co v. Koelling*, 729 S.W.2d 251 (Mo. App. 1987); *Allstate Prop. & Cas. Ins. Co. v. Bee*, 2009 WL 1124973 (W.D. Mo. Apr. 27, 2009).

Maverick, 2010 WL 2635623, at *6. The court rejected *Maverick*'s attempts to rely on two cases where the insureds were not manufacturers but a distributor and an installer. *See id.* at *6–*7 (discussing *Maurice Pincoffs Co v. St. Paul Fire & Marine Ins. Co.*, 447 F.2d 204, 206–07 (5th Cir. 1971); *Lennar Corp. v. Great Am. Ins. Co.*, 200 S.W.3d 651, 681–83 (Tex. App.—Houston [14th Dist] 2006, pet. denied)). Unlike in those cases, the liability causing event was *Maverick*'s defective manufacturing of the drill casing as all of the damage flowed from that manufacturing defect. “Like the insured in *Puget Plastics*, *Maverick* would have been subject to liability for the defect regardless of who installed or sold the drill casing to the customer.” *Id.* at *7. Using the “cause” analysis, the court found there was only a single occurrence. The court emphasized that “the critical fact is the ‘number of causal events, not the number of claims or claimants,’” when analyzing the number of occurrences issue. *Id.* Thus, there only was a single occurrence under the policy.⁸

C. Commentary

Although based primarily on Missouri law, the *Maverick Tube* case nevertheless is important. The court's discussion of the difference between manufacturers and distributors or installers is notable because of the effect it has on the “number of occurrences” issue. In particular, when dealing with product failures, an insured is more likely to be able to aggregate the losses into a single “occurrence.” The court reiterated the majority rule that the “cause” of the insured's liability and not the number of injurious effects controls.

X. *Mid-Continent Casualty Co. v. Academy Development, Inc.*, 2010 WL 3489355 (S.D. Tex. Aug. 24, 2010)

On August 24, 2010, the U.S. District Court for the Southern District of Texas reissued its opinion in *Mid-Continent Casualty Co. v. Academy Development, Inc.*, 2010 WL 3489355 (S.D. Tex. Aug. 24, 2010), vacating its prior order from March 24, 2010, and substituting this order in its place. In the new opinion, the court granted *Academy*'s motion for partial summary judgment and denied *Mid-Continent*'s motion for partial summary judgment.

A. Background

Academy Development Inc., along with *Chelsea Harbour, Ltd.*, *Legend Classic Homes, Ltd.* and *Legend Home Corp.* (collectively “*Academy*”), developed the lake-front *Chelsea Harbour* subdivision in Fort Bend County, Texas. On or about May 23, 2005, a group of subdivision homeowners (the “*Budiman* plaintiffs”) alleged *Academy* knew at the time they sold the homes the lake walls were falling and water was leaking from the lakes onto the home sites. The *Budiman* plaintiffs brought claims of statutory fraud, negligence, negligent representation and DTPA violations. The jury ultimately returned a verdict for *Academy*. *Id.* at *1.

Legend Classic Homes, Ltd. was a named insured under five CGL policies issued by *Mid-Continent*. The other defendants were all listed as additional named insureds on the policies.

⁸ The court also addressed issues involving the segregation of covered and uncovered claims, recovery of attorneys' fees and recovery of prejudgment interest, but discussion of the court's findings are beyond the scope of this paper.

The policies themselves were identical except for variations in the deductible amount per policy⁹ and some provided the deductible applied to defense costs. *Id.* Initially, Mid-Continent agreed to defend Academy, but after the Budiman plaintiffs filed their ninth amended petition, Mid-Continent argued it no longer had a duty to defend Academy because that petition did not allege claims of “property damage.” *Id.* at *2. Mid-Continent filed the declaratory judgment action, seeking a ruling that it did not owe a defense or indemnity to Academy. Mid-Continent and Academy agreed to file cross-motions for summary judgment as to whether Mid-Continent had a duty to defend and, based on the policies triggered, how the defense costs should be allocated across the policies. *Id.*

B. Duty to Defend

“Under the eight corners rule, the duty to defend is determined by the claims alleged in the petition and the coverage provided in the policy.” *Id.* at *4 (quoting *Pine Oak Builders, Inc. v. Great Am. Lloyds Ins. Co.*, 279 S.W.3d 650, 654 (Tex. 2009)). The court noted that to “[r]esort to evidence outside the four corners of these two documents is generally prohibited.” *Id.* (quoting *Nautilus Ins. Co. v. Country Oaks Apartments, Ltd.*, 566 F.3d 452, 454 (5th Cir. 2009)).

The parties’ dispute centered on the presence of allegations of “property damage” in the ninth amended petition filed by the Budiman plaintiffs. No dispute existed that such allegations existed in the first eight petitions, as the underlying plaintiffs alleged, among other things, “drywall cracks, joint separation in trim and windows, tiles breaking, mortar cracks, and windows cracking without impact.” In the ninth amended petition, however, the claims of physical damage to the homes were removed and replaced with allegations of diminution of value and possible future damage to the homes.

The policies defined “property damage” as:

- 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 cause it, or
- b. Loss of use of tangible property that is not physically injured. All such loss of use shall be deemed to occur at the time of the “occurrence” that caused it.

Id. at *5. Academy argued the ninth, tenth and eleventh petitions included allegations sufficient to satisfy the above definition. Specifically, the petition alleged: “Defendants breached [their duties of care] and that such acts and/or omission constitute the proximate cause of Plaintiffs’ damage *including cost of repair and diminution of value to their homes.*” *Id.* The court initially noted the “cost of repair” language actually referred to the cost of repairing the lakes, not the homes. *Id.* at *5–*6. Nevertheless, the court recognized the policies cover “damages because of ‘property damage’” and no requirement exists that the damage be to property owned by the underlying plaintiffs. Thus, the court declined to read such additional terms into the policy. *Id.* at

⁹ The deductibles were as follows: 2000–2001: \$1,000 per claim; 2001–2002: \$5,000 per claim; 2002–2003: \$5,000 per claim; 2003–2004: \$50,000 per occurrence; and 2004–2005: \$100,000 per occurrence.

*6. The underlying petitions allege the diminution in value of their homes was caused by water leaking onto the plaintiffs' property from the damaged lakes. According to the court, "[t]his is an allegation of damages caused by physical damage to tangible property (the lake) and is sufficient to allege property damage per the terms of the policies." *Id.*

Having determined the petitions alleged claims of "property damage," the court considered whether the damage to the lakes occurred during at least one of the policy periods. *Id.* (citing *Don's Building Supply, Inc. v. OneBeacon Ins. Co.*, 267 S.W.3d 20, 31 (Tex. 2008) ("[T]he insurer's duty to defend depends on whether the homeowners' pleadings allege property damage that occurred during the policy term.")). This is known as the "actual injury" rule in Texas, which deems property damage occurred for the purposes of the policy "when actual physical damage to the property occurred." *Id.* at *7 (quoting *Don's Building Supply*, 267 S.W.3d at 24). In the Budiman petitions, the court acknowledged it was not entirely clear when the damage to the lakes began, but the petitions referenced letters issued in February 2004 and September 2005, as well as a 2002 lawsuit regarding the lakes' faulty construction. The court was able to conclude, based on the Budiman petition that the damage occurred "at some point prior to 2002," and that the "continuous leaking caus[ed] damage to the Budiman plaintiffs." *Id.* As a result, the court determined Mid-Continent had a duty to defend Academy after the filing of the Budiman plaintiffs' ninth amended petition. *Id.*

C. Defense Cost Allocation

Although the parties agreed that all five Mid-Continent policies potentially were triggered, they disagreed how the defense costs should be allocated across them. Academy argued they were entitled to pick which policy applied, and Mid-Continent argued the defense costs should be apportioned pro rata across the policies. The basis for Academy's argument was the D.C. Circuit opinion, *Keene Corp. v. Insurance Co. of North America*, 667 F.2d 1034, 1047–49 (D.C. Cir. 1981), which held that once coverage is triggered, each insurer is independently liable to fully indemnify the insured up to the policy's limit, subject to "other insurance" clauses. The court recognized this approach was adopted by the Supreme Court of Texas in *American Physicians Insurance Exchange v. Garcia*, 876 S.W.2d 842 (Tex. 1994), and later extended specifically to the duty to defend in *Texas Property & Casualty Insurance Guaranty Ass'n v. Sw. Aggregates, Inc.*, 982 S.W.2d 600 (Tex. App.—Austin 1998, no pet.).

Mid-Continent argued in response that, while Texas has adopted the *Keene* reasoning, the Fifth Circuit has not. In particular, Mid-Continent noted decisions in which the duty to defend was prorated across triggered policies. *Academy*, 2010 WL 3489355, at *8 (citing *Gulf Chem & Metallurgical Corp. v. Associated Metals & Minerals Corp.*, 1 F.3d 365 (5th Cir. 1993); *Lafarge Corp. v. Hartford Cas. Ins. Co.*, 61 F.3d 389 (5th Cir. 1995)). Moreover, Mid-Continent urged the court to adopt its position because Academy had contractually agreed to bear part of the defense costs in those policies in which the deductibles apply to defense costs. *Id.* The court rejected Mid-Continent's position, though, recognizing the Fifth Circuit cases on which Mid-Continent relied were issued before *Southwest Aggregates* and more recent Fifth Circuit opinions acknowledging and supporting Texas' adoption of *Keene*. See, e.g., *Trinity Universal Ins. Co. v. Employers Mut. Cas. Co.*, 592 F.3d 687, 695 (5th Cir. 2010); *Indian Harbor Ins. Co. v. Valley Forge Ins. Group*, 535 F.3d 359, 363 (5th Cir. 2008). As a result, in granting Academy's motion for summary judgment, the court adopted the reasoning in *Keene/Garcia* and found Academy

was entitled to select the policy from among the triggered policies that would provide a complete defense. Academy selected the policy effective from August 1, 2000 to August 1, 2001, which provided a complete defense and had a \$1,000 per claim deductible which did not apply to defense costs.

D. Commentary

The decision in *Academy* is important for its recognition that CGL policies cover “damages *because of* property damage” with no limitation that the property damaged be owned by the claimant. Additionally, and more importantly, the court’s decision to adhere to *Keene* and allow Academy to select the policy providing its defense is significant and reinforces the principle that an insurer owes a complete defense under any triggered policy year.

XI. *National Union Fire Insurance of Pittsburgh, Pa. v. Puget Plastics Corp.*, 2010 WL 3362117 (S.D. Tex. Aug. 25, 2010)

On August 25, 2010, the Southern District of Texas issued its opinion in *National Union Fire Insurance of Pittsburgh, Pa. v. Puget Plastics Corp.*, 2010 WL 3362117 (S.D. Tex. Aug. 25, 2010) (“*Puget III*”), considering the defendant and intervenor’s motion for a new trial, or alternatively, to alter or amend the prior judgment. The court denied the motion.

A. Background

Microtherm, the intervenor in the case, manufactured tankless water heaters. Puget Plastics Corp. (“Puget”) manufactured the plastic water chambers Microtherm installed in their heaters. Around April 2001, the chambers began to fail and leak, and, in 2002, Microtherm sued Puget alleging they had intentionally under-heated the plastic chambers during the manufacturing process. The jury agreed with Microtherm and found Puget engaged in false, misleading, or deceptive acts or practices; engaged in unconscionable action; failed to comply with warranties; engaged in negligent misrepresentation; and committed fraud. Microtherm decided to forego the fraud findings and obtained a judgment against Puget for \$36,081,807.

National Union Fire Insurance (“National Union”) insured Puget as an additional insured under an umbrella policy from July 1, 1999 to July 1, 2002. After the jury verdict, National Union filed the present action seeking a declaration that it had no duty to defend or indemnify Puget for the claims asserted in the state court action. Microtherm intervened, having assumed Puget’s rights as an insured party through a settlement agreement. In *National Union Fire Insurance Co. v. Puget Plastics Corp.*, 649 F. Supp. 2d 613 (S.D. Tex. 2009) (“*Puget II*”), the court held National Union did not have a duty to defend or indemnify Puget. *Id.* at 656. Puget/Microtherm filed a motion for a new trial, or in the alternative, to alter or amend the judgment.

B. “Highly Probable”

In its final judgment in the case, the district court found no accident had occurred and, therefore, no “occurrence” existed under the National Union policy. Analyzing that issue required the court, by mandate of the Fifth Circuit, to determine whether the damage incurred

was “highly probable.” Puget objected to the court’s findings, arguing the determination should be *objective* not purely *subjective*.

A central issue in the *Puget* case was “whether a jury’s finding of a knowing violation of the [DTPA] could ever constitute an ‘accident’ under Texas insurance law.” The district found such a knowing violation *could* constitute an accident, and the district court permitted an interlocutory appeal to the Fifth Circuit, which affirmed the conclusion. *See National Union Fire Insurance Co v. Puget Plastics*, 532 F.3d 398 (5th Cir. 2008) (“*Puget I*”). The Fifth Circuit held:

deliberate acts may constitute an accident unless: (1) *the resulting damage was “highly probable” because it was the “natural and expected result of the insured’s actions,”* (2) “the insured intended the injury,” or (3) the insured’s acts constituted an intentional tort, in which case, the insured was presumed to have intended the injury.

Id. at 401–402 (citing *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 242 S.W.3d 1, 8 (Tex. 2007)). Following *Puget I*, the district court, in *Puget II*, found Puget’s conduct was not an accident and, thus, did not constitute an accident. *See Puget II*, 649 F. Supp. 2d at 646. In doing so, the court applied an objective “highly probable” standard, so as not to render the subjective “intended the injury” prong of the Fifth Circuit test superfluous. *Puget III*, 2010 WL 3362117, at *3. In response, in *Puget III*, Puget raised several objections to the objective standard.

First, Puget contended the phrase “from the viewpoint of the insured” in the Policy’s definition of “occurrence” mandated the use of a subjective standard. Disagreeing, the court noted the definition of “occurrence” involves two inquiries: (1) whether an accident occurred; and (2) whether the injury or damage was expected or intended “from the viewpoint of the insured.” *Id.* at 2. Thus, the viewpoint language did not modify “accident.” Even assuming for the sake of argument that the language was intended to be part of the accident inquiry, the court determined there was “nothing inconsistent or erroneous” about applying an objective standard as “Texas courts have often looked to what the insured knew at the time of the conduct in question, then asked whether a reasonable person, in similar circumstances and knowing what the insured knew, would have expected the damage or injury that resulted from the conduct.” *Id.* at *4 (citation omitted). Additionally, the court rejected Puget’s argument that the Supreme Court of Texas rejected an objective standard in *Lamar Homes*. The Southern District court noted *Lamar Homes* simply stated that an earlier Supreme Court of Texas decision “did not adopt foreseeability as the boundary between accidental and intentional conduct. *Id.* (citing *Lamar Homes*, 242 S.W.3d at 8). “This language does not necessarily indicate that an objective standard would be problematic, but that a simple question of foreseeability is not sufficient to determine whether or not an act or conduct constitutes an ‘accident’ under Texas insurance case law.” *Id.* Also, the federal court in *Puget III* rejected Puget’s reliance on *Tanner v. Nationwide Mutual Fire Insurance Co.*, 289 S.W.3d 828 (Tex. 2009) (addressing specific policy language shaping the accident inquiry into a subjective one), and on *King v. Dallas Fire Insurance Co.*, 85 S.W.3d 185 (Tex. 2002) (addressing the viewpoint from which an event is to be viewed but not discussing whether the standard was to be objective or subjective). *Puget III*, 2010 WL 3362117, at *5. Thus, the court reaffirmed its holding that the Fifth Circuit’s decision in *Puget I* mandated the use of an objective “highly probable” standard. *Id.* at *6. Using that objective standard, the *Puget III* court found Puget’s deliberate lowering of the melting temperature made it “highly

probable” damage would result to Microtherm’s final product. *See id.* (citing *Puget II*, 649 F. Supp. 2d at 646).

C. Alternate “Accident” Test

Despite its conclusion in the “highly probable” discussion, the *Puget III* court recognized that because the parties to the suit had differing opinions on the current status of the “accident” case law in Texas, it felt “compelled to offer a review of Texas and Fifth Circuit Court of Appeals cases . . . [to discuss] what constitutes an ‘accident’ under Texas law.” *Id.* at *6. The court summarized the cases on the subject, and, in doing so, determined the current status of the “accident” definition:

[A] finding that an insured party intentionally but haphazardly or negligently, engaged in particular conduct is not the end of the inquiry. A court making such a finding must also ask whether the injury or damage that resulted would have resulted regardless of the insured party’s negligence. If a court finds that the damage would have resulted even if the insured party had performed the intentional act in question flawlessly, then, for insurance purposes, there was no accident. If, however, the damage occurred only as a result of the poor performance of the intentional act, then there was an accident.

Id. at *9. Notably, the court also addressed the Supreme Court of Texas’ definition of accident in *Lamar Homes*, which found:

[A] claim does not involve an accident or occurrence when either direct allegations purport that the insured intended the injury (which is presumed in case 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. at *10 (quoting *Lamar Homes*, 242 S.W.3d at 9). The Southern District of Texas noted the *Lamar Homes* definition did not address instances in which a deliberate act intentionally performed (albeit possibly wrongfully performed) leads to injury or damage not intended by the insured. *Id.* Thus, the court found the law to be unchanged and, in such situations, “a court must ask whether the resulting injury or damage was reasonably foreseeable from the viewpoint of the insured.” *Id.* (citing *Mid-Century Ins. Co. v. Lindsey*, 997 S.W.2d 153, 155 (Tex. 1999)).

As Puget objected not only to the court’s use of the Fifth Circuit standard, but also argued that the Fifth Circuit’s analysis of Texas case law was incorrect, the *Puget III* court opted to develop an alternate test (which it emphasized still reached the same conclusion as the Fifth Circuit standard). The court offered the following alternate test:

A court must first look to the chain of events leading up to the injury or property damage in question and identify the final deliberate or intentional act by the insured that took place prior to the injury or damage. If that intentional act caused the injury or property damage, the court must ask: (1) was this act an intentional tort committed by the insured, (2) did the insured intend the resulting injury, or (3) was the resulting injury reasonably foreseeable/did it naturally follow from the

viewpoint of the insured? If the answer to any part of that question is “Yes,” then no accident has occurred. If the answer is “No” to all three parts of that question, then an accident may have occurred. . . .

If, on the other hand, after identifying the last intentional act of the insured in the chain of events, a court determines that some subsequent careless intervening act or the poor execution of the intentional act or defective product actually caused, in whole or in part, the injury, then the court must ask itself whether the injury or property damage was highly probable had the careless intervening act not occurred or the intentional act not been executed poorly. If the answer to that question is “Yes,” i.e., the injury or damage would have occurred regardless of the carelessness or poor performance of the insured, then there was no “accident.” The injury or damage would have resulted regardless of whether there were flaws in the insured's conduct. If, however, the answer to the court's question is “No,” then an “accident” may have occurred under the policy because the injury or damage would not have occurred absent the insured's negligence or substandard conduct.

Id. at *11 (internal footnotes and citations omitted). The court conceded this analysis was more cumbersome than the Fifth Circuit test, but found it more inclusive and comprehensive while still being consistent with *Lamar Homes*. *Id.* at *12.

The court then applied this new test to the facts of the case. Puget’s lowering the melting temperatures was an intentional act. The act, while possibly ill-advised, was not performed negligently nor was it followed by intervening negligence. It also was the cause of the damage Microtherm suffered. Thus, the facts fit the first part of the court’s test. Next, the court considered whether the damage was either (1) intended by Puget or (2) reasonably foreseeable from the viewpoint of Puget. As the court previously found no intent on Puget’s part to injure or damage Microtherm, it did not re-evaluate this position. With regard to reasonable foreseeability, the court acknowledged the objective “highly probable” standard indicated a level of certainty greater than reasonable foreseeability, and Puget did not disagree. As the court previously determined the injury to Microtherm was “highly probable,” it follows that the injury also was reasonably foreseeable from Puget’s viewpoint. Thus, the court concluded no accident occurred under Texas law and denied Puget’s motion to alter or amend with regard to whether an “accident” occurred. *Id.* at *13–*14.

D. Failure to Allocate Damages

Puget’s second argument was that the court erroneously held they had a duty to allocate among covered and non-covered damages and that Puget failed to do so. *See Puget III*, 2010 WL 3362117, at *15. In asserting this argument, Puget relied primarily on *United Services Automobile Association v. Lambert*, 1999 WL 695704 (Tex. App.—Austin Aug. 26, 1999, no pet.), for the proposition that the allocation requirement was not absolute. The court disagreed, finding *Lambert* stood only for a limited carve-out in the context of mental anguish damages. *Lambert*, according to the court, did not “loosen the rigidity” of the allocation requirement set forth in *Travelers Indemnity Co. v. McKillip*, 469 S.W.2d 160 (Tex. 1971), and *Lyons v. Millers Casualty Insurance Co.*, 866 S.W.2d 597 (Tex. 1993). Puget, the court maintained, did not

provide any reason to extend the *Lambert* case to the present facts. See *Puget III*, 2010 WL 3362117, at *16.

Having affirmed Puget's requirement to allocate between covered and non-covered damages, the court turned its attention to the impaired property exclusion. *Id.* at *17. Puget urged that the award of damages in the state court all were covered—and, hence, no need existed for allocation. *Id.* The court reaffirmed the application of the exclusion, though, and rejected Puget's argument that the chambers no longer were Puget's "product" because they had been altered by Microtherm after leaving Puget's factory. If that were true, the exclusion would not apply in the first instance and all the damages caused by the leaky chambers would be covered. The court found this new argument to be disingenuous in light of the fact it never had been raised in eight years of litigation. *Id.* at *18. Accordingly, the court then addressed Puget's contention that the exception to the impaired property exclusion applied, which reinstated coverage for damages caused by sudden and accidental physical injury to the insured's product. *Id.* at *19. The court found the testimony in the state court trial was clear that the cracks in the chambers were not "sudden and accidental," though, and refused to apply the exception to the impaired property exclusion. *Id.*

Because the state court verdict was based on covered and non-covered damages, the court then determined Puget failed to satisfy their duty of allocation. Puget was required to (1) distinguish which portion of damages assessed against Puget were the result of covered property damage, and (2) distinguish the damages assessed against Puget from those assessed against the other defendants. *Id.* According to the court, Puget failed to do either. Based on the numerous experts that testified in *Puget II*, the court stood by its original holding that there was "simply no reasonable, reliable, non-arbitrary basis supported by a preponderance of the evidence in the record upon which to allocate economic damages between covered and non-covered risks." *Id.* (quoting *Puget II*, 649 F. Supp. 2d at 652). The court's analysis of the testimony presented resulted in a finding that, for purposes of allocation, it was "totally insufficient and amounts to rank speculation and guesswork." *Id.* at *22. Moreover, even if such evidence was credible, Puget still did not allocate the damages among the various state-court defendants. *Id.* The court noted Puget's argument that the jury verdict provided the proper allocation, but ultimately held that the court was required to review the record itself and reach the conclusion based on the actual evidence. *Id.* at *23. Again, the evidence presented simply was insufficient. *Id.* See also *Dana Corp. v. Microtherm*, 2010 WL 196939 (Tex. App.—Corpus Christi Jan. 21, 2010, pet. filed) (finding as to another defendant in the state court trial that "the evidence was legally insufficient to support the divisible lost value damages awarded against [that defendant]"). Thus, the court concluded that, with respect to allocation of damages, it was not "reasonably clear that prejudicial error crept into the record or that substantial justice [had] not been done." *Sibley v. Lemaire*, 184 F.3d 481, 487 (5th Cir. 1999). As Puget failed to carry their burden of allocation, according to the court, their motion for a new trial or to alter or amend the judgment on that basis also was denied.

E. Commentary

The Southern District of Texas' opinion in *Puget III*, while not correct in this author's opinion, provides a thorough analysis of the standard CGL policy's "occurrence" requirement, as interpreted by Texas courts. In doing so, though, the court seemingly has read the subjective

component of the “occurrence” definition out of the policy. The court also went the extra step of creating an alternative test for determining whether an intentional act ever can be an accident. Although creative, the court’s alternative test is confusing and difficult to apply. In each analysis, the court found—albeit incorrectly—that Puget’s intentional act of lowering the temperature during the creation of the water chambers was not an accident and was the sole cause of the “property damages” at issue. The use of a “highly probable” test, which is based on an objective standard, arguably is inconsistent with *Lamar Homes* and could—if affirmed—have a negative impact on coverage for construction defects claims.