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IN THIS ISSUE:

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Taking *Gilbert* (the Case not the Comic Strip) Too Far

On April 28, 2011, Judge Janis Graham Jack extended the Supreme Court of Texas' decision in *Gilbert Texas Construction, L.P. v. Underwriters at Lloyd's London*, 327 S.W.3d 118 (Tex. 2010), finding that a lawsuit against a general contractor did not trigger an insurer's duty to defend (or indemnify) because of applicability of the "contractual liability" exclusion found in the standard-form ISO commercial general liability insurance policy. *See Ewing Construction Co., Inc. v. Amerisure Ins. Co.*, 2011 WL 1627047 (S.D. Tex. Apr. 28, 2011). In doing so, Judge Jack wholly ignored the requirement in the exclusion of an "assumption" of liability, extended *Gilbert* beyond its unique fact pattern, and applied *Gilbert* to the duty to defend by applying the "economic loss" rule—a liability defense—to ignore the negligence claims that remained pending against Ewing in the underlying construction defect lawsuit. Effectively, Judge Jack's decision renders the "property damage" component of CGL coverage virtually meaningless when the damages complained of in an underlying lawsuit are restricted to the contracted-for work itself—even when coverage would otherwise exist because of the subcontractor exception to the "your work" exclusion.

A. Background Facts

Ewing, who was insured by Amerisure under four consecutively-issued standard CGL insurance policies, was sued on February 25, 2010 by the Tuloso-Midway Independent School District for damages caused by allegedly deficient construction of a tennis facility in Corpus Christi, Texas. Ewing had contracted with the school district to serve as general contractor on the project. *Id.* at *1. Ewing tendered the lawsuit to Amerisure for a defense and indemnity, but Amerisure denied the duty to defend. Amerisure maintained its denial through subsequent amendments to the allegations in the underlying lawsuit. *Id.* As a result, Ewing filed suit against Amerisure seeking a declaration that Amerisure had an obligation to defend Ewing, that in failing to do so Amerisure breached its duty to defend, and also violated Texas' Prompt Payment of Claims Act. *Id.* Amerisure counterclaimed, seeking a declaration that it had no duty to defend or indemnify Ewing. *Id.* The parties agreed to stipulated facts and cross-moved for summary judgment. *Id.*

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B. Analyzing Coverage – Satisfaction of the Insuring Agreement

After setting forth the general standards for the duty to defend and indemnify, the court explained that it had to evaluate whether the claims in the underlying lawsuit fell within the broad scope of coverage under the policies. And, if so, whether an exclusion applied to negate coverage. If an exclusion applied, the court then had to analyze whether an exception to such an exclusion reinstated coverage. *Id.* at *4.

At the outset, the court noted that Amerisure seemingly conceded that the claims against Ewing by Tuloso-Midway satisfied the policies' insuring agreement. In particular, Tuloso-Midway sought damages that Ewing would be "legally obligated to pay" as a result of "property damage" caused by an "occurrence" during the policy period. *Id.* The court found the "property damage" element was "clearly satisfied," as allegations existed of tennis court cracking and flaking. *Id.* Such allegations clearly constituted "physical injury to tangible property." *Id.*

Likewise, the "occurrence" requirement also was satisfied, as there were allegations of "negligent construction." Under the Supreme Court's decision in *Lamar Homes, Inc. v. Mid-Continent Casualty Co.*, 242 S.W.3d 1 (Tex. 2007), such allegations are sufficient to constitute an "occurrence." *Ewing*, 2011 WL 1627047 at *5 (citing *Lamar Homes*, 242 S.W.3d at 8–9, 16). And, finally, no dispute existed that the damage allegedly occurred during one or more of the effective policy periods. *Id.*

C. The "Contractual Liability" Exclusion

Knowing the insuring agreement was satisfied, and because the allegations clearly fell within the subcontractor exception to the "your work" exclusion, Amerisure relied entirely on application of the "contractual liability" exclusion in arguing that a duty to defend did not exist. Specifically, Amerisure argued that a CGL policy "is designed to cover fortuitous events that are beyond the insured's control," and it does not cover "contractual liability that the insured voluntarily assumes." *Id.* (quoting Amerisure's briefing). The court noted that the Supreme Court has said:

> **Coverage under a commercial general liability insurance policy is for tort liability for physical damages to others and not for contractual liability of the insured for economic loss because the product or work is not that for which the damaged person bargained.** Pursuant to this understanding, certain exclusions have been included within the standard commercial general liability policy for the express purpose of excluding coverage for risks relating to the repair or replacement of the insured's faulty work or products, or defects in the insured's work or product itself. These "business risk" exclusions, as they are commonly called, are intended to provide coverage for tort

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liability, not for the contractual liability of the insured for loss which takes place due to the fact that the product or completed work was not that for which the other party had bargained.

Id. at *5–*6 (quoting *Zurich Am. Ins. Co. v. Nokia, Inc.*, 268 S.W.3d 487, 500 (Tex. 2008) (emphasis added); *see also Lamar Homes*, 242 S.W.3d at 10 ("More often . . . faulty workmanship will be excluded from coverage by specific exclusions because that is the CGL's structure. The CGL's insuring agreement grants the insured broad coverage for property damage and bodily injury liability, which is then narrowed by exclusions that restrict and shape the coverage otherwise afforded.") (citations omitted)).

In relevant part, the contractual liability exclusion provides as follows:

> This insurance does not apply to:
>
> **b. Contractual Liability**
>
> "[B]odily injury" or "property damage" for which the insured is obligated to pay damages by reasons of the assumption of liability in a contract or agreement. This exclusion does not apply to liability for damages:
>
> (1) That the insured would have in the absence of the contract or agreement; or
>
> (2) Assumed in a contract or agreement that is an "insured contract" . . . .

And, Judge Jack stated, the Supreme Court has explained that "such an exclusion '[c]onsidered as a whole, . . . provide[s] that the policy does not apply to bodily injury or property damage for which the insured is obligated to pay damages by reason of an 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 *6. Thus, according to the Supreme Court, the exclusion is not limited to situations where "the insured assumes the liability of another, such as in an indemnity or hold-harmless agreement," but rather "the exclusion's language applies without qualification to liability assumed by contract [with two exceptions]." *Id.* (quoting *Gilbert*, 327 S.W.3d at 128–29). That is, the exclusion "applies when the insured assumes liability for bodily injuries or property damages by means of contract, unless an exception to the exclusion brings a claim back into coverage or unless the insured would have liability in the absence of the of the contract or agreement." *Id.* (quoting *Gilbert*, 327 S.W.3d at 132).

Judge Jack went on to note that the Supreme Court had cited several cases holding "as we [the Supreme Court] do." *Id.* (citing *CIM Ins. Corp. v. Midpac Auto Center, Inc.*, 108 F. Supp. 2d 1092, 1099–1100 (D.

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Hawai'i 2000) (finding that any claim dependent on the existence of an underlying contract is not covered by insurance); *TGA Dev., Inc. v. N. Ins. Co. of N.Y.*, 62 F.3d 1089 (8th Cir. 1995) (finding coverage precluded for contractual claims made because of the contractor's failure to provide a condominium unit free of defects); *Monticello Ins. Co. v. Dismas Charities, Inc.*, 1998 WL 1969611, at *2 (W.D. Ky. Apr. 3, 1998) ("[Defendant's] assertion that this exclusion only applies to situations where a party 'contractually assumes the liability for another party,' goes against the plain meaning of the policy language. Liability under a contract does not arise only when a party assumes the liability for another party. Any party to a contract assumes potential liability under the agreement.")). But, as correctly noted by Judge Jack, the Supreme Court was clear that the exclusion does not bar *all* breach of contract claims. *Id.* (citing *Gilbert*, 327 S.W.3d at 128, which found that the exclusion bar claims when the insured assumes liability for damages in a contract). Even so, Judge Jack concluded:

> Gilbert, therefore, stands for the proposition that the contractual liability exclusion applies when an insured has entered into a contract and, by doing so, has assumed liability for its own performance under that contract.

Id. Importantly, Judge Jack noted in a footnote: "This Court's reading of *Gilbert* is in line with what appears to be a *quite expansive interpretation* of the 'assumption of liability' phrase in the contractual liability exclusion." *Id.* at *6 n.5 (emphasis added).

Addressing the issue of "assumption" the court said that Ewing assumed liability with respect to its own work on the tennis courts, which were the subject of the contract. *Id.* at *7. According to the underlying lawsuit, Ewing impliedly represented that it would build quality tennis courts lasting twenty-five years. *Id.* But Ewing failed to do, according to Tuloso-Midway, which claimed Ewing breached its contract, breached an implied duty of ordinary care, breached an implied warranty of good workmanship, breached an implied warranty of merchantable quality, breached an implied warranty that the tennis courts would be suitable for their intended purpose and breached an express warranty that it would execute the work in the contract. *Id.* Thus, Judge Jack concluded that "Ewing assumed liability for its own construction work pursuant to the parties' contract" because "Ewing is liable if the work it agreed to perform under that contract is defective." *Id.* "Applying *Gilbert*, the Court concludes that Ewing assumed liability for its own defective work when it entered into the contract with Tuloso–Midway for construction of the tennis courts at issue." *Id.* The court summarily dismissed Ewing's argument that the instant case was more in line with *Lamar Homes* than *Gilbert*, noting that the contractual liability exclusion was not at issue in *Lamar Homes*. *Id.* at *8. Moreover, the court said it relied on *Gilbert* for its "legal interpretation" of the exclusion, essentially rejecting Ewing's argument that *Gilbert* involved the duty to indemnify only and the instant case dealt with the duty to defend. *Id.* Thus, the court concluded

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that the exclusion applied in the circumstances before it, noting, however:

> The Court recognizes Ewing's concern that "Amerisure's interpretation of the Contractual Liability exclusion would essentially wipe out any coverage for a general contractor for 'property damage' that occurs to the project." While the Court may not read *Gilbert* as broadly as Amerisure does, and indeed makes no general findings about its application beyond this case, it does agree with the conclusion that it operates to exclude coverage in the present circumstances and in that sense is quite broad in application.

Id. at *8 n.7.

D. The Exception to the Exclusion

Having found the contractual liability exclusion applied, the court turned to Ewing's argument that the exception for liability that "the insured would have in the absence of the contract or agreement" applied to reinstate at least the potential for coverage and thus a duty to defend. *Id.* In particular, Ewing argued that because claims for negligence also existed alongside the breach of contract claims in the underlying lawsuit, liability existed (or at least potentially existed for purposes of the duty to defend) in the absence of the contract. Amerisure countered that, notwithstanding the pending negligence claims, claims actually sound solely in contract and that no liability exists independent of the contract between the parties. *Id.*

In evaluating the parties' arguments, the court relied on the Fifth Circuit Court of Appeals' decision in *Century Surety Co. v. Hardscape Construction Specialties, Inc.*, 578 F.3d 262 (5th Cir. 2009), where the court allegedly confronted a similar situation to the one before the court in *Ewing*. *See Ewing*, 2011 WL 1627047, at *8. In that case, the court analyzed whether the "insured contract" exception to the contractual liability exclusion was applicable. *Id.* at *9. That exception only was triggered if the underlying petition "properly alleges a tort cause of action against Hardscape under the 'eight corners' rule applied by Texas courts." *Id.* (quoting *Hardscape*, 578 F.3d at 266) (noting the *Hardscape* analysis was directly relevant notwithstanding the fact that it analyzed a different exception than raised by Ewing because the definition of "tort liability" was the same as in the applicable exception). Focusing on the difference between common law tort claims and breach of contract causes of action, the Fifth Circuit said:

> To determine the nature of a Texas lawsuit, we must look to the substance of the cause of action and not necessarily the manner in which it was pleaded. Texas courts characterize actions as tort or contract by focusing on the source of liability and the nature of the plaintiff's loss:

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> . . . Tort obligations are in general obligations that are imposed by law-apart from and independent of promises made and therefore apart from the manifested intention of the parties-to avoid injury to others. If the defendant's conduct-such as negligently burning down a house-would give rise to liability independent of the fact that a contract exists between the parties, the plaintiff's claim may also sound in tort. Conversely, if the defendant's conduct-such as failing to publish an advertisement-would give rise to liability only because it breaches the parties' agreement, the plaintiff's claim ordinarily sounds only in contract.
>
> **In determining whether the plaintiff may recover on a tort theory, it is also instructive to examine the nature of the plaintiff's loss. When the only loss or damage is to the subject matter of the contract, the plaintiff's action is ordinarily on the contract.**

Id. (quoting *Hardscape*, 578 F.3d at 267 (internal citations omitted) (emphasis added)).

Looking specifically at the allegations in the underlying lawsuit in *Hardscape*, the Fifth Circuit said most of them easily were classified as giving rise only to contract claims because the damages at issue occurred only to the subject matter of the contract. Because no allegations existed that the faulty construction damaged the owner's business interests or adjacent property, the damages all only existed as a result of the contract. Thus, the court in *Hardscape* concluded the exception did not apply. *Id.* (discussing *Hardscape*, 578 F.3d at 267–70).

Applying *Hardscape*, Judge Jack explained that the damages complained of by Tuloso-Midway in its lawsuit against Ewing related solely to the subject matter of their contract—the tennis courts. "Tuloso-Midway does not claim damages to, or seek recovery for, any other property on the school grounds not covered by the contract." *Id.* Judge Jack said:

> This analysis necessarily leads to the conclusion that Tuloso–Midway's claims against Ewing in the Underlying Lawsuit sound only in contract, not tort, consistent with *Hardscape*. As such, the Court must conclude that the exception to the contractual liability exclusion, providing for coverage for liability that "the insured would have in the absence of the contract or agreement," is not applicable.

Id. at *12.

Accordingly, despite the fact that the negligence claims remained pending against Ewing, Judge Jack held that Amerisure did not have a duty to defend. And, for the same reasons that negated the duty to defend, Judge Jack also held that Amerisure never would have a duty to indemnify Ewing in connection with the underlying lawsuit. *Id.* (citing

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Farmers Tex. County Mut. Ins. Co. v. Griffin, 955 S.W.2d 81, 84 (Tex. 1997)). Further, because no duty to defend existed, Amerisure was not liable under Texas' Prompt Payment of Claims Act. *Id.* (citing *Progressive County Mut. Ins. Co. v. Boyd*, 177 S.W.3d 919, 922 (Tex. 2005)).

Commentary:

Well, if *Gilbert* was not bad enough, *Ewing* sure makes things a lot worse for insureds that do business pursuant to contracts. Essentially, the "property damage" coverage under a CGL policy is virtually worthless under Judge Jack's extension of the contractual liability exclusion—at least where the construction is performed pursuant to a contract and the damages are to the contracted-for work. The decision is wrong on so many levels. *Gilbert* was bad—this is worse. And it is difficult to understand Judge Jack's comment that she does not read the exclusion as broadly as Amerisure. We at the Shidlofsky Law Firm cannot fathom a scenario in which the exclusion could be applied even more broadly.

First, entirely missed in the opinion was the concept of an "assumption" as used in the contractual liability exclusion. While the Supreme Court made clear in *Gilbert* that the contractual liability exclusion did not preclude coverage for *all* breach of contract claims, Judge Jack basically said it did (although she did note it was an "expansive" reading). In *Gilbert*, the Court went to great pains to highlight the *specific* assumption of liability in the contract that went beyond Gilbert Texas Construction's "common law" obligations. Notably, because of governmental immunity, Gilbert could not have been liable "but for" its contractual assumption. Here, Judge Jack seemingly concluded that general contractors "assume" liability *every time they enter into a contract*. That is a scary interpretation and one that contravenes the very intent behind the contractual liability exclusion and the evolution of the CGL policy as a whole. Simply put, the facts in *Gilbert* were somewhat unique. The *Ewing* case, on the other hand, is a garden-variety construction defect lawsuit.

Second, even assuming there was an "assumption" of liability sufficient to trigger the contractual liability exclusion, Judge Jack wholly ignored the fact that *Gilbert* was a duty to indemnify case and the issue in *Ewing* was whether a duty to defend existed. Judge Jack quickly dismissed that argument, failing to recognize that the duty to defend is broader than the duty to indemnify. Judge Jack also failed to recognize that the Supreme Court in *Gilbert* made a point of distinguishing between the duty to defend and the duty to indemnify. In fact, that was one of the primary bases on which the Supreme Court distinguished *Lamar Homes.* Even worse, in applying *Gilbert* to the duty to defend, Judge Jack utilized a liability defense (i.e., the "economic loss" rule) to render an advisory opinion that the negligence claims pending against Ewing in the underlying lawsuit were not "viable." That has never been part of the duty to defend analysis and directly contradicts the statement in *Lamar Homes* that the economic loss rule is not a useful tool for determining insurance coverage. Thus, whether ultimately viable or not, the

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negligence claims clearly existed in the underlying lawsuit, and, thus, a potential for liability existed in the absence of the contract or agreement between Ewing and Tuloso-Midway. Therefore, the second exception to the contractual liability exclusion should have applied to reinstate at least a duty to defend. Interestingly, while those negligence claims were not "viable" according to Judge Jack when analyzing the exception to the exclusion, the court relied on the very same allegations to conclude that an "occurrence" existed as a matter of law. Now you see it . . . now you don't.

The ultimate outcome of this case will depend on the Fifth Circuit's (or, on certification, the Supreme Court of Texas') interpretation of *Gilbert.* In *Gilbert*, the Supreme Court rejected Gilbert's claim that the Court's decision would result in a finding of no coverage whenever liability defenses knock out the negligence claims against a contractor and leave only claims for breach of contract. Hmm, sound familiar. In response, the Court said:

> We understand Gilbert's concerns, but 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.

Gilbert, 327 S.W.3d at 135. Well, this is that case—that "fully developed, actual case" where a small alteration in the facts warrants a completely different result than in *Gilbert*. That is, coverage should exist where the insured did not assume specific liability beyond its common law obligations. Moreover, a duty to defend certainly should exist when alternative allegations of negligence remain pending against the insured. And, a coverage court should not be allowed to issue an advisory ruling as to the application of liability defenses such as the economic loss rule.

Ewing has filed an appeal to the Fifth Circuit and requested that the following issues be certified to the Supreme Court of Texas:

I. Does a general contractor that enters into a contract in which it agrees to perform its construction activities in a good and workmanlike manner "assume liability" within the meaning of the Contractual Liability Exclusion?

II. Did the Supreme Court of Texas' holding in *Gilbert Texas Construction, L.P. v. Certain Underwriters at Lloyd's London*, 327 S.W.3d 118 (Tex. 2010), with respect to the Contractual Liability Exclusion in the indemnity context, extend to the duty to defend?

III. If the Answer to Question II is "Yes," do tort allegations in the underlying lawsuit fall within the exception in the Contractual Liability Exclusion for "liability that would exist in the absence of the contract"? Or, is the judge in the coverage case permitted to evaluate the merits of the other claims (such as applying the "economic loss" rule to negligence allegations) in determining the duty to defend?

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Amicus briefs have been filed supporting the certification and supporting Ewing's interpretation on the contractual liability exclusion. Hopefully, this case will be the catalyst for getting the Supreme Court to limit its holding in *Gilbert.* Or, of course, this could be the catalyst for the Supreme Court to make its *minority* interpretation of the contractual liability exclusion (the term "minority" is not being used loosely—it's not even close) in *Gilbert* even worse. Let's say a prayer for the former. For now, stop entering into construction contracts or agreements. Rather, just call them "memos of understanding." ☺

*NOTE – In the event this Newsletter finds its way to any justice of the Supreme Court of Texas or a judge on the Fifth Circuit Court of Appeals, all the sarcasm contained herein was placed by an associate who immediately was fired from the Shidlofsky Law Firm.

GETTING TO KNOW SHIDLOFSKY LAW FIRM PLLC . . .

Lee H. Shidlofsky is a founding member of Shidlofsky Law Firm PLLC. His practice is devoted to representing and counseling corporate policyholders in the area of insurance law, risk management, contractual risk transfer, and extra-contractual issues. He is the Immediate Past Chair of the Insurance Law Section and a former council member of the Construction Law Section of the State Bar of Texas. He is the author of numerous articles and seminar papers and is a frequent speaker at continuing legal education seminars in Texas and across the country. Lee has been named a "Super Lawyer" by Texas Monthly Magazine each year since 2004, including a ranking as a Top 50 attorney in the Central and West Texas Region since 2007, and is ranked as a top insurance coverage lawyer by Chambers USA and Who's Who Legal. Lee also is a Fellow of the Texas Bar Foundation.

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