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# insurance law newsletter

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5th Circuit clarifies recovery of "damages because of 'property damage,'" rejects ownership requirement for "property damage" and allows insured to select defending policy

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## Damages Because of "Property Damage", No Ownership Interest Required and Picking the Defending Policy: A "Trifecta" for Policyholders

On April 20, 2012, the United States Fifth Circuit Court of Appeals affirmed the Southern District of Texas, scoring a "trifecta" for Texas policyholders. *See Mid-Continent Cas. Co. v. Academy Dev., Inc.*, 2012 WL 1382459 (5th Cir. Apr. 2012), *aff'g.*, 2010 WL 3489355 (S.D. Tex. Aug. 24, 2010). In particular, the Fifth Circuit confirmed that economic damages flowing from "property damage" constitute "damages *because of* . . . 'property damage,'" a claimant need not own the physically damaged property at issue in order to trigger an insured's liability coverage and an insured covered by consecutively issued CGL policies can pick any one of the triggered policies to provide a complete defense.

### A. Background Facts

Academy Development, Inc. and its related entities developed and built a residential neighborhood in Texas. A key component of the construction of the development was the lake that served as a focal point of the lakeside community. *Academy Dev.*, 2012 WL 1382459 at *1.

In 2005, the developer entities were sued in Texas state court by a group of individual purchasers of homes in the neighborhood (the "Underlying Lawsuit"). The claimants alleged that the developers knew when the homes were sold that the lake walls were failing and water was leaking onto the adjacent home sites. Among other things, the claimants sought damages for diminution in the value of their homes because of the defective lakes. In 2008, the Underlying Lawsuit was tried to a jury and the developers prevailed. *Id.*

At all relevant times, the developers were insured under five consecutive commercial general liability insurance policies issued by Mid-Continent. The policies contained standard CGL insuring agreements, providing that coverage applied to "those sums that the insured becomes legally obligated to pay as damages because of . . . 'property damage,'" so long as the "property damage" occurred during the policy period. In turn, "property damage" was defined in relevant part as "physical injury to tangible property." In most respects, the policies were identical, but the deductible on each policy varied and some of the deductibles applied to defense costs while others did not. *Id.*

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**Cases to Watch:**

*Ewing Construction Co., Inc. v. Amerisure Ins. Co.*, 814 F. Supp. 2d 739 (S.D. Tex. 2011) (pending in the Fifth Circuit; oral argument held on March 6, 2012) (scope of the "contractual liability" exclusion where "property damage" is limited to the scope of the insured's work)

*Crownover v. Mid-Continent Cas. Co.*, Civil Action No. 3:09-CV-2285 (N.D. Tex. Jan. 13, 2011) (pending in the Fifth Circuit; oral argument held on March 7, 2012) (scope of the "contractual liability" exclusion in the residential construction defect context)

Initially, Mid-Continent defended the developers in the Underlying Lawsuit pursuant to a reservation of rights. When the Ninth Amended Petition was filed, however, Mid-Continent withdrew the defense, contending that no allegations existed of "property damage" sufficient to trigger coverage. Earlier versions of the petition specifically had included claims of physical damage to sheetrock, trim, windows, tiles and mortar, but those allegations were removed in the Ninth Amended Petition. *Id.*

In January 2008, Mid-Continent filed suit against its insureds, seeking a declaration that it had no duty to defend or indemnify them upon filing of the Ninth Amended Petition. The parties cross-moved for summary judgment addressing two issues: (1) whether a duty to defend existed from the Ninth Amended Petition forward; and (2) how the defense costs incurred by the developers should be apportioned among the triggered policies. On the second issue, the key question was whether the developers could select a single triggered policy to provide a complete defense of the Underlying Lawsuit or whether the defense costs should be apportioned *pro rata* among all the triggered policies. *Id.* at *2.

The district court ruled in favor of the insureds on both accounts. The district court said that the diminution in value of the claimants' homes because of the damaged lakes alleged "damages because of . . . 'property damage.'" The district court further ruled that it did not matter whether the claimants' owned the damaged lakes for purposes of determining the duty to defend. Moreover, the insureds were allowed to select one policy under which their defense was to be provided even though the deductible provisions varied among the consecutively-triggered policies. Mid-Continent appealed both rulings to the Fifth Circuit.

**B. "Damages Because of . . . 'Property Damage'" and the Duty to Defend**

After addressing the well-established "eight corners" rule for determining the duty to defend, the Fifth Circuit noted that no dispute existed that the claimants in the Underlying Lawsuit sought damages for, among other things, diminution in the value of their homes. *Id.* at *3. Moreover, "the 'damages because of . . . "property damage"' provision in a CGL policy includes recovery sought for economic losses, such as diminution in value, that are 'attributable' to property damage." *Id.* (citation omitted). Thus, so long as allegations existed in the Underlying Lawsuit of "property damage" that caused the diminution in value, Mid-Continent's duty to defend was triggered.

On that issue, the court found that "property damage" existed on two fronts: (1) the property on which the claimants' homes sat; and (2) the lakes adjacent to those properties. With respect to the claimants' property, the court found that the claimants sought damages for diminution in the value of their homes that was attributable to damage to their property, as distinct from the damage to their homes. The court quoted the allegations:

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> [T]he walls of the Lakes were breaking apart and . . . water was leaking from the Lakes into the adjacent properties upon which Plaintiffs' homes were located.
>
> Upon information and belief, continuous and excessive water leakage from the Lakes that flow laterally and under the Plaintiffs' homes and properties may have caused structural damage to Plaintiffs' homes and foundations. Over time, this will cause Plaintiffs to incur excessive repair costs to the foundations and structures of their homes.
>
> Plaintiffs contend in this lawsuit that the failure of the Lakes directly affects the value of the homes in the community.

*Id.*

Acknowledging that the allegations of physical injury to the homes were phrased in "uncertain terms," the allegations—even when read liberally—were insufficient to allege "property damage" under the Mid-Continent policies. *Id.* Nevertheless, the court noted that the pleadings referenced the "homes *and properties*," which the court found could be "reasonably read to distinguish between their houses and their other property (land under and surrounding the house, *e.g.*, lawn bordering lake)." *Id.* In other words, according to the Fifth Circuit, the uncertain language in the pleadings only applied to the claimants' homes, and the allegations of water leaking onto their *properties* was not uncertain and was sufficient to constitute "property damage" that affected the value of the homes. *Id.*


Alternatively, the court found that the claimants alleged diminution in the value of their homes that was attributable to the damaged lakes, which also was sufficient to trigger Mid-Continent's duty to defend. In particular, the claimants alleged in the Underlying Lawsuit:

> [T]he Lakes and wall were not property designed and constructed . . ., the walls had excessive cracks and displacements . . ., water was escaping under and around the sloped paving, between the sloped paving and the wall, at the outfall structure, perhaps through the clay liner at greater depths, through cracks in the wall, and other similar problems.
>
> [T]he condition of the Lakes had substantially decreased the value of the Chelsea Harbour subdivision; specifically, a loss of value from approximately $6.5 million to $2.25 million dollars for a loss in diminution of value in the range of $3.75 to $4.5 million dollars.

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> Plaintiffs will show that the problems with the Lakes have affected the value of their property and their homes. Plaintiffs maintain a good faith belief that the condition of the Lakes has in the past, and continues, to cause damage to the value of their residential properties.
>
> Plaintiffs contend in this lawsuit that the failure of the Lakes directly affects the value of the homes in the community. . . . Plaintiffs' homes and properties have suffered diminution of value due to the past, present and future conditions of the Lakes.
>
> Defendants owed multiple duties of care regarding . . ., construction of the Lakes, and the protection of Plaintiffs' property interests, including but not limited to the repair work performed on the Lakes. . . . Defendants were . . . negligent in the hiring and supervision of the entities that both constructed and repaired the Lakes. . . . Plaintiffs would show that all Defendants breached the above described duties and that such acts . . . constitute the proximate cause of Plaintiffs' damages, including cost of repair and diminution of value to their homes.
>
> Plaintiffs would also show that Defendants failed to construct and/or repair the Lakes in a good and workmanlike manner.


*Id.* at *3–*4. Those allegations were sufficient to constitute "property damage" under *Lamar Homes, Inc. v. Mid-Continent Casualty Co.*, 242 S.W.3d 1, 4 (Tex. 2007). Accordingly, the pleading alleged property damage to the lakes that resulted in the diminution in the value of the claimants' homes. *Academy Dev.*, 2012 WL 1382459 at *4.

Mid-Continent, however, claimed that even if the lakes were damaged, a defense still was not triggered because the claimants did not have an ownership interest in the lakes. *Id.* The court disagreed, noting that a similar argument by Mid-Continent previously had been rejected by the court. *Id.* (citing *Mid-Continent Cas. Co. v. Bay Rock Oper. Co.*, 614 F.3d 105 (5th Cir. 2010)). In that case, the court specifically held that "[n]othing in the Policies require the claimant . . . to have an ownership interest in the property that was damaged for coverage to exist." *Id.* at *5 (quoting *Bay Rock*, 614 F.3d at 111).

Applying that same logic to the policies before it, the court again found that Mid-Continent's policies do not require a claimant to have an ownership interest in the property damaged by the insured's operations. *Id.* Under Texas law, the court was required to give the policy's terms their plain meaning without reading additional language into the contract. *Id.* (citation omitted). Moreover, the court noted that the "only relevant inquiry" is whether a duty to defend was triggered—not whether

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the claimants had standing to bring the Underlying Lawsuit in the first instance. *Id.*

### C. Picking a Policy to Defend—It Is in the Insured's Hands

Having agreed that a duty to defend existed, the court addressed Mid-Continent's claim that it could apportion the insureds' defense costs across all five triggered policies. In the last three years, the deductible was significantly higher *and* applied to defense costs, whereas the first two policies had low deductibles that did not apply to defense costs. *Id.* Apportioning the defense costs across the five policies would have significantly reduced the amount of defense costs owed by Mid-Continent and would have come at significant expense to the insureds.

The Fifth Circuit did not accept Mid-Continent's position, noting that "Texas courts have rejected the *pro rata* method for calculating an insurer's duty to defend when more than one policy is triggered by a claim." *Id.* (citing *Tex. Prop. & Cas. Ins. Guar. Ass'n v. Sw. Aggregates, Inc.*, 982 S.W.2d 600, 604–07 (Tex. App.—Austin 1998, no pet.); *CNA Lloyds of Texas v. St. Paul Ins. Co.*, 902 S.W.2d 657, 661 (Tex. App.—Austin 1995, writ dism'd)). The court explained that the reasoning behind the rule was that once an insurer's policy is triggered, "the insurer's duty is to provide its insured with a complete defense." *Id.* (quoting *Sw. Aggregates*, 982 S.W.2d at 606). "This is because the contract obligates the insurer to *defend* its insured, not to provide a *pro rata* defense." *Id.* (quoting *Sw. Aggregates*, 982 S.W.2d at 606 (emphasis in original)). Accordingly, the Fifth Circuit held that the district court did not err in allowing the insureds to select any one of the five triggered policies to provide the defense.

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**Commentary:**

With the Fifth Circuit's decision in *Academy Development*, policyholders scored an important victory. The court's reaffirmation that economic losses—in this case, diminution in value—can be covered by a CGL policy is an important aspect of CGL coverage. While it is undisputed that coverage for the actual "property damage" itself is important, sometimes the economic losses arising *because of* such damage are much more financially significant. Yet, policyholders are oftentimes wrongfully informed that CGL policies do not protect against economic losses. Moreover, the court clarified a point that Mid-Continent and some other insurers continue to raise against policyholders—there simply is no ownership requirement in a CGL policy when it comes to determining whether allegations of "property damage" exist. As the Supreme Court of Texas said five years ago, policies are supposed to be written in plain English, not code and the plain English of the policy does not include any such ownership requirement. Likewise, whether the claimants had standing to sue for damage to the lakes constituted a liability defense—not a coverage defense.

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Most significantly, the Fifth Circuit's clear rejection of a *pro rata* allocation of defense costs may prove to be the most beneficial aspect of the court's decision. Oftentimes allegations will trigger a number of consecutively issued CGL policies and, as was the case in *Academy Development*, the deductibles (or SIRs) applicable to each can drastically impact the value of the defense obligation. Allowing the insured to select the policy under which it is defended puts some control of the defense back in the hands of the policyholder.

Shidlofsky Law Firm was proud to represent the insureds in this matter. Here's hoping that this is the beginning of a good year for Texas policyholders . . .

## GETTING TO KNOW SHIDLOFSKY LAW FIRM PLLC . . .

Lee H. Shidlofsky is the 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, Best Lawyers in America, and Who's Who Legal. Lee also is a Fellow of the Texas Bar Foundation.

Douglas P. Skelley is a senior associate at Shidlofsky Law Firm PLLC. He represents and counsels corporate policyholders in numerous insurance law matters. He is a member of both the Insurance Law Section and the Construction Law Section of the State Bar of Texas. Doug has been named a Texas "Rising Star" by Texas Monthly Magazine each year since 2010.

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

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