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

THE POLICYHOLDERS' PERSPECTIVE

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On July 19, 2013, the Amarillo Court of Appeals issued an important ruling touching on two long-standing principles of Texas insurance law: the *Stowers* doctrine and the application of *Gandy*. *See Yorkshire Ins. Co., Ltd. v. Seger*, 407 S.W.3d 435 (Tex. App.—Amarillo 2013, pet. denied).

A. Background Facts

The facts surrounding the underlying lawsuit that led to *Seger* are extensive. The lawsuit arises out of the death of a man in 1992 while working on an oil rig owned by Diatom Drilling Co., L.P. The man, Randall Jay Seger, did drilling work for both Diatom and Employer's Contractor Services, Inc. ("ECS") and, on the day in question, he was employed by ECS and providing services to Diatom. Diatom was insured by a Lloyd's of London-type commercial general liability insurance policy at the time of the accident, and the subscribing insurers were notified of the accident. Then, after Seger's parents filed suit against Diatom, its partners, and ECS, the Insurers were notified, but they ultimately refused to provide a defense, "contending that Randall's death was not a covered occurrence and that Diatom failed to provide timely notice of suit." *Id.* at 436.

Seger's parents made two policy-limits settlement demands and then a $250,000 settlement demand, but all them were refused by the Insurers. The underlying lawsuit proceeded to trial after the plaintiffs non-suited all the defendants except for Diatom. At the trial, Diatom's principal, Cynthia Gilliam, was subpoenaed to attend and did attend as a witness, but she did not appear in a representative capacity on behalf of Diatom. According to the court of appeals, her participation was consistent with that of a witness and not a party. Diatom was not represented by counsel in any way. After the trial, the court entered judgment in favor of each parent to the tune of $7.5 million plus interest. *Id.* at 436–37.

Thereafter, Gilliam contacted Diatom's Insurers about satisfying the judgment, but she did not receive a response. Accordingly, Diatom assigned its rights against the Insurers to the Segers (save and except for the right to recover Diatom's attorneys' fees incurred in defending the underlying suit). The Segers then filed a *Stowers* action against the Insurers for their wrongful failure to settle the underlying case within policy limits. *Id.* at 437.

The Segers ultimately settled with all the Insurers except Yorkshire and Ocean Marine. By way of pretrial summary judgment, the trial court found that the parties in the underlying suit were in a "fully adversarial relationship" and that the proceeding was a "trial." Thus, all that remained to be determined in the *Stowers* case was the Insurers' negligence, causation and damages. The court ordered a directed verdict on damages based on the underlying judgment and submitted the other issues to the jury, which returned a verdict in favor of the Segers. *Id.* In the court of appeals' first bite at the case, the court agreed that the underlying plaintiffs had made a sufficient demand within policy limits. However, the court reversed the judgment in all other respects and remanded the case for a new trial. *Id.*

On retrial, the case was submitted to a jury. "Based on the jury's findings, the trial court entered a judgment that recites that the Segers' claims were covered by the CGL insurance policy, and that the underlying judgment was the result of a fully adversarial trial and, therefore, establishes the Segers' damages as a matter of law." *Id.* at 438. Each parent was awarded more than $35 million, which was the current amount of the previously issued underlying judgment. *Id.* The Insurers then appealed again, raising seven issues. The court of appeals addressed only the first issue, which it found to be dispositive, and that issue was that the evidence was legally and factually insufficient to establish that Diatom was damaged by the insurers. *Id.*

B. A "Fully Adversarial Trial"

According to the Insurers, the Segers' only evidence of their damages was the underlying judgment that had been issued. However, because that judgment was not obtained through a fully adversarial trial, the Insurers argued that was insufficient evidence of the damages. *Id.* (citing *State Farm Fire & Cas. Co. v. Gandy*, 925 S.W.2d 696, 714 (Tex. 1996)). In response, the *Segers* contended that, under *Evanston Insurance Co. v. ATOFINA Petrochemicals, Inc.*, 256 S.W.3d 660, 671–72, 674 (Tex. 2008), the *Gandy* requirement of a fully adversarial trial is inapplicable where an insurer wrongfully fails to provide a defense to its insured or wrongfully denies coverage.

Addressing the *ATOFINA* decision, the Amarillo Court of Appeals noted that the Supreme Court in *ATOFINA* discussed the effect of *Gandy* on another of its decisions, *Employers Casualty Co. v. Block*, 744 S.W.2d 940, 943 (Tex. 1988), where the Court held that an insurer cannot challenge the reasonableness of a settlement amount as part of an agreed judgment if the insurer wrongfully denied coverage. The Court ultimately held that *Gandy* did not apply to the settlement agreement in *ATOFINA* because of two key distinctions: (1) there was no assignment; and (2) there were no *Gandy* concerns. More specifically, ATOFINA had not assigned its claim against Evanston to anyone and sued Evanston directly. As to the concerns raised in *Gandy*, the Court found that preventing insurers from litigating the reasonableness of a settlement shortens a dispute rather than extending it, and no risk of distorting litigation or settlement motives existed because, at the time of the settlement, ATOFINA did not know whether coverage ultimately would exist or not. Thus, *Block* was applied to bar Evanston from challenging ATOFINA's settlement agreement and found *Gandy* wholly inapplicable. *See Seger*, 407 S.W.3d at 439–40.

Relying on that holding, the Segers argued that the Insurers could not challenge the underlying judgment because they failed to defend Diatom and denied coverage. The Amarillo Court of Appeals disagreed, however, concluding "that the arrangement between Diatom and the Segers does not meet *ATOFINA's* exception to *Gandy*." *Id.* at 440. First, Diatom had assigned its rights against its Insurers to the Segers so, unlike in *ATOFINA*, that key factual predicate of *Gandy* existed. *Id.* Second, the concerns of *Gandy* also were present because the assignment by Diatom specifically was made to prolong the litigation and allow the Segers to pursue the Insurers, as Diatom was judgment-proof and each of its principals had been non-suited. *Id.* at 440–41. Moreover, the assignment also distorted the litigation. "Because neither Diatom nor its principals had any financial exposure in the underlying trial, unlike ATOFINA, Diatom had no

incentive to contest its liability or to attempt to limit the assessment of damages after it was found liable." *Id.* at 441 (citations omitted). Additionally, as assignee of the *Stowers* claim, the Segers had to argue that they would not have recovered more than policy limits against Diatom if Diatom had been provided a defense. But the reality was that they recovered $15 million. "In fact, the Segers argued to the trial court in their *Stowers* action that admission of the amount of damages recovered by them in the underlying proceeding would be 'completely prejudicial.'" *Id.*

In light of the foregoing, the court of appeals was left to assess whether Diatom's assignment was valid and whether, under *Gandy*, the underlying judgment was the result of a fully adversarial trial. *Id.* According to the court, the assignment was obtained after the underlying proceeding took place, the Insurers refused to tender a defense to Diatom, and the Insurers neither accepted coverage nor made a good faith effort to adjudicate coverage prior to the adjudication of the Segers' claims. As such, under *Gandy*, the assignment was valid. *Id.*

Turning to the "fully adversarial trial" requirement, the court quoted its prior decision in the case in which it discussed that requirement:

> When the judgment is an agreed judgment, default judgment, or when the underlying defendant's participation is so minimal as to evidence that the hearing was not adversarial, the judgment resulting from that hearing may not be admitted as evidence of damages in the *Stowers* action.

Id. at 442 (quoting *Yorkshire Ins. Co., Ltd. v. Seger*, 279 S.W.3d 755, 772 n.25 (Tex. App.—Amarillo 2007, pet. denied)). Looking at the evidence before it, the court found that "Diatom's participation was so minimal that we cannot conclude that the underlying judgment was the result of a fully adversarial trial." *Id.* Moreover, with respect to the evidence presented for the Segers' damages, no evidence was submitted to support the $7.5 million awards issued to each parent. Accordingly, it was clear to the court that the Segers' claims against Diatom were not "fairly determined" by that proceeding. *Id.* Thus, the court ruled "that the underlying judgment was not only not conclusive as to the damages suffered by Diatom, but is inadmissible as evidence of damages in the present action." *Id.* at 443. And, because that was the only evidence of damages that was presented, the Segers' claims failed and the court of appeals ordered the trial court to render judgment that the Segers take nothing. *Id.*

Commentary:

While the decision in *Seger* certainly touches on the *Stowers* doctrine, it is clear that the central holding is that *Gandy's* requirement for a fully adversarial trial still exists. More importantly, although *ATOFINA* seemed to suggest that the wrongful denial of coverage would enable an insured to settle its case as it deemed fit, the reality is that specific requirements of *Gandy* must still be attained if the underlying claimant wants to bind the insurer to an underlying judgment that it obtains. To do so, a claimant must obtain a valid assignment of the claim (at least for extra-contractual claims) and participate in a fully adversarial trial against the insured. Without one or both requirements satisfied, an underlying judgment *may* not hold up against an insurer.

II. *Mid-Continent Casualty Co. v. Krolczyk*, 408 S.W.3d 896 (Tex. App.—Houston [1st Dist.] 2013, pet. denied)

In mid-August 2013 and on rehearing, the First Court of Appeals in Houston issued a decision on an agreed interlocutory appeal involving an insurer's duty to defend its insured in connection with an underlying lawsuit wherein the insured was sued for its work on a road construction project. *See Mid-Continent Cas. Co. v. Krolczyk*, 408 S.W.3d 896 (Tex. App.—Houston [1st Dist.] 2013, pet. denied). In a somewhat confusing opinion, the court ultimately ruled that the duty to defend existed and rendered judgment for the insured.

A. Background Facts

Robert Krolczyk owned land in Waller County that he subdivided and sold as home sites. As part of the project, he built a road through the middle of the subdivision, the base of which he completed in 2000 and the paving and sealing of which was completed in 2003. *Id.* at 899. In 2006, Krolczyk sued the neighborhood's maintenance association for damaging the road, alleging that they moved dumptruck-loads of earth over the road despite his objection. He sought declaratory relief regarding the parties' rights and responsibilities for the repairs and the homeowner's association intervened and counterclaimed against Krolczyk for building a "totally inadequate" road that resulted from faulty construction. *Id.*

Krolczyk tendered the lawsuit to his insurer, Mid-Continent, for a defense and indemnity, and Mid-Continent agreed to defend him subject to a reservation of rights. Ultimately, though, Mid-Continent contended that coverage did not exist, so Krolczyk filed the instant declaratory judgment action against the company. In response, Mid-Continent argued that exclusion j.(6)[1] and an "earth movement" exclusion applied to negate coverage. After the trial court denied the parties' cross-motions for summary judgment, the parties filed an agreed interlocutory appeal. *Id.* at 901.

B. Analysis by the Court of Appeals

With respect to exclusion j.(6), the court noted that liability coverage does not apply when two conditions are met: (1) the property damage is to "[t]hat particular part" that must be restored, repaired, or replaced (2) because the insured incorrectly performed work on it. *Id.* at 902 (citing *Mid-Continent Cas. Co. v. JHP Dev., Inc.*, 557 F.3d 207, 215 (5th Cir. 2009). And the court emphasized that an exclusion that purports to unambiguously precludes coverage for *all* property damage caused by the insured's defective work should omit limiting language that references "that particular part" of property. *See id.* (citing *Gore Design Completions, Ltd. v. Hartford Fire Ins. Co.*, 538 F.3d 365, 371–72 (5th Cir. 2008) (construing the "that particular part" language not to exclude coverage for the insured's nondefective work damaged by defective work performed elsewhere in the same project)). Thus, "[t]he exclusion only precludes

[1] The court routinely refers to this exclusion as the "your work" exclusion throughout the opinion. However, because exclusion *l.* is the "your work" exclusion, and to prevent any confusion, it is referred to as exclusion j.(6) herein.

coverage for repairing or replacing the insured's defective work; 'it does not exclude coverage for damage to other property resulting from the defective work.'" *Id.*(citing *Wilshire Ins. Co. v. RJT Const., L.L.C.*, 581 F.3d 222, 226 (5th Cir. 2009) (citing *Travelers Ins. Co. v. Volentine*, 578

S.W.2d 501, 503 (Tex. Civ. App.—Texarkana 1979, no writ)); *see also Mid–Continent Cas. Co. v. Bay Rock Operating Co.*, 614 F.3d 105, 115–16 (5th Cir. 2010) (holding that the j.(6) term restricts the exclusion to property damage to that particular part of the project that was subject to the insured's defective work); *Gore Design*, 538 F.3d at 371–72 (same)).

Looking to the allegations of the underlying lawsuit, the court noted that Krolczyk built the road in three phases: (1) the drainage ditches and road base of the whole road were constructed and he laid asphalt on the first third of the road; (2) eighteen months later, he laid asphalt on the second third of the road; and (3) finally, he laid the remainder of the asphalt on the road. *Id.* at 902–03. In phases 2 and 3, Krolczyk did not "rework" the road base, which—along with the allegedly inadequate drainage—formed the basis of the HOA's claims with respect to the resulting damage to the road surface that cracked and exhibited potholes after less than one year of use. *Id.* at 203.

Turning back to *JHP*, Mid-Continent claimed that, unlike in that case, all the work performed by Krolczyk was alleged to have been defective as opposed to just a portion of it. The court, however, said that the allegations were not that clear. Rather, the HOA had alleged that the asphalt laid on the surface of the road cracked, but no allegations existed that the surfacing work was defective. *Id.* at 903–04. Instead, the surface was alleged to have cracked because of the insured's failures with respect to the road base. *Id.* at 904. Accordingly, applying Texas law, only the defectively performed work would be excluded, such as the work on the road base, while the non-defectively performed work would be covered, such as his paving and repaving work. *Id.* Importantly, the court rejected Mid-Continent's argument that the road should be considered a unitary whole so as to minimize the limitation of "that particular part." *Id.* at 904–05 (noting that the allegations clearly separated the work into three phases and recognizing that such a large project lends itself to the use of various construction techniques, equipment and materials, which makes it comparable to projects like that at issue in *JHP*). Thus, the court found the exclusion did not negate coverage.

The court also found that the "earth movement" exclusion did not apply. In doing so, the court noted that, other than allegations concerning the road base, no allegations existed that the road damage was related to the movement of land, earth or mud. *Id.* at 905. The ordinary meanings of those words would not include concrete or other man-made materials, so Krolczyk's interpretation of the exclusion that limits its application was adopted by the court. *Id.* Because the pleadings did not specify whether the "part of the [road] base" that was "exposed to the elements" and washed out was built of land, earth or mud, the exclusion did not negate the duty to defend. Simply put, because the road base could have been built of materials *other* than earth, land or mud, and the allegations did not mention any other earth movement, the duty to defend still existed. *Id.* at 906.

Commentary:

The *Krolczyk* decision further delineates the narrow application of exclusion j.(6)—and exclusion j.(5), although it was not mentioned in the decision—because of the limiting language found therein that only precludes coverage for "that particular part" of an insured's work that is defective. The case also illustrates the critical importance of an underlying plaintiff's pleadings. Had the plaintiff not alleged that the road was constructed in three phases and emphasized the separation of those phases, the same result may not have existed. Although not monumental by any means, the court's ruling with respect to the "earth movement" exclusion also illustrates that same point. Had it been alleged that the earth or land *under* the road base had been washed out, causing the surface to crack, the court may have reached an altogether different conclusion.

III. *Mid-Continent Casualty Co. v. Castagna*, 410 S.W.3d 445 (Tex. App.—Dallas 2013, pet. denied)

Just a few days after *Krolczyk* was issued, the Dallas Court of Appeals opined on two key duty to defend issues—namely, when "property damage" occurred so as to determine which policy (or policies) were triggered and whether the "contractual liability" exclusion operated to negate coverage. *See Mid-Continent Casualty Co. v. Castagna*, 410 S.W.3d 445 (Tex. App.—Dallas 2013, pet. denied). While the trial court ruled in the insured's favor, on appeal the court affirmed in part and reversed in part.

A. Background Facts

The Castagnas contracted with McClure Brothers Custom Homes, LP to build a residence in Frisco, which was completed in late 1999. In 2008, Mrs. Castagna filed suit against McClure Brothers in connection with problems with the foundation of the home. Mid-Continent defended the builder in that lawsuit, which was subject to arbitration, and in which Castagna obtained an arbitration award that ultimately was confirmed. Castagna then sued McClure Brothers' insurers (although she ultimately non-suited Great American) for indemnity for the final judgment confirming the arbitration award. Her motion for summary judgment was granted and this appeal followed. *Id.* at 447–48.

B. When Did Covered "Property Damage" First Occur?

Mid-Continent contended that the arbitration award did not trigger policies covering the 2001 to 2002 and 2002 to 2003 time periods, but *only* triggered the 2006-2007 policy. The court noted that the relevant policy provisions were standard CGL provisions like those at issue in *Don's Building Supply, Inc. v. OneBeacon Insurance Co.*, 267 S.W.3d 20 (Tex. 2008), where the Supreme Court of Texas held that property damage "occurred when the home in question suffered wood rot or some other form of physical damage." *Castagna*, 410 S.W.3d at 450–51. (quoting *Don's Bldg.*, 267 S.W.3d at 30). Moreover, the court found that Mid-Continent was bound by the findings of the arbitration. *Id.* at 452 (citation omitted).

In that regard, the arbitrator's findings were that cracks commenced in 2001 and progressed through late 2006 or early 2007. *Id.* at 453. "Further, the arbitrator found the foundation failure and resulting damage were the unintended result of McClure Brothers Custom Homes, LP's and its subcontractors' failure to design and construct a foundation that was capable of withstanding the movement of the soil which resulted in a structural failure of the foundation of part of the residence." *Id.* Thus, the court found Mid-Continent's claim that such cracks were not "property damage" caused by an "occurrence," but rather the result of normal shrinkage or settling, was unpersuasive. *Id.* at 454. As such, the court held that property damage occurred during the three policy periods at issue and, therefore, each of them was triggered. *Id.*

Undeterred Mid-Continent also argued that the arbitrator's failure to apportion damage in each of the policies and Castagna's failure to present any independent evidence of such an apportionment meant that Castagna could not prevail as a matter of law. The court, however, disagreed, noting that Mid-Continent relied on case law discussing the doctrine of concurrent causes and the requirement that an insured apportion or distinguish covered losses from noncovered losses. *Id.* "Mid-Continent has provided no authority to support an argument that Castagna had the burden to prove an allocation of covered property damage to particular policy periods." *Id.* at 454–55 (citing *Keene Corp. v. Ins. Co. of N. Amer.*, 667 F.2d 1034, 1047–49 (D.C. Cir. 1981) (finding that it is the insured's right to select which of the triggered policies provides indemnification; each insurer is fully liable for indemnification); *see also Amer. Physicians Ins. Exch. v. Garcia*, 876 S.W.2d 842, 855 (Tex. 1994) (finding that if a single occurrence triggers more than one policy covering different policy periods, the insured may select from multiple consecutive insurance policies the one under which it is to be indemnified; "insured's indemnity limit should be whatever limit applied at the single point in time during the coverage periods of the triggered policies when the insured's limit was highest")). Thus, on that ground, the court affirmed the lower court's decision.

C. Application of Exclusions to Coverage

After ultimately determining that no coverage existed under the 2006-2007 policy because the judgment was against a different entity than the named insured on that policy, the court turned back to the two earlier policies and addressed whether any exclusions negated coverage. In particular, the court focused on the "your work" exclusion and the "contractual liability" exclusion.

With respect to the "your work" exclusion, the court clarified that the subcontractor exception to that exclusion remained intact on the policies at issue from 2001 to 2003. However, that exception was removed by endorsement on the 2006-2007 policy. Nevertheless, because the court already determined that coverage did not exist under the later policy, the removal of the exception was irrelevant. And, further, because no dispute existed that subcontractors performed the work in question and because the 2001-2003 policies were triggered, the exception would apply in those policies to reinstate coverage that otherwise would have been excluded for damage to the insured's own work. *Id.* at 457–58.

Finally, the court addressed the applicability of the "contractual liability" exclusion in each of the policies. Mid-Continent argued that no evidence existed of a non-contractual basis under which McClure Brothers' liability was established. Rather, the only liability was based on the breach of the implied warranty of good workmanship that was created by contract. *Id.* at 460. Because the arbitrator awarded attorneys' fees under Section 38.001 of the Texas Civil Practice and Remedies Code, Mid-Continent argued that the breach of implied warranty claims sounded in contract and, therefore, fell within the exclusion under the reasoning of *Gilbert Texas Constr., L.P. v. Underwriters at Lloyd's London*, 327 S.W.3d 118 (Tex. 2010). In response, Castagna contended that the implied warranty of good workmanship arises under the common law and, therefore, was not a liability that the insured "assumed" for purposes of the contractual liability exclusion, but was liability imposed for breach of the common law implied warranty. *Castagna*, 410 S.W.3d at 461.

After reviewing the decision in *Gilbert*—in which the same exclusion negated coverage for damage to a third-party property that Gilbert had agreed by contract to protect and repair—the court found it was unpersuaded by Mid-Continent's expansive interpretation of the holding in *Gilbert*. *Id.* at 463. Rather, the court agreed that the implied warranty was not an "assumed" liability because it would have existed in the absence of the contract. In other words, the insured, unlike in *Gilbert*, "did not assume any contractual obligation in addition to, or that extended beyond, the 'general law' of implied warranty of good workmanship." *Id.* (citing *Gilbert*, 327 S.W.3d at 127; *see also Sipes v. Longford*, 911 S.W.2d 455, 457 (Tex. App.—Texarkana 1995, writ denied) ("Implicit in every contract is a common-law duty to perform the terms of the contract with care, skill and reasonable experience.")). "The construction contract does not include any provision enlarging the contractor's obligations beyond performance of its construction work in a good and workmanlike manner, and accordingly there is not an assumption of liability for damages sufficient to trigger the contractual liability exclusion." *Id.* (citing *Gilbert*, 327 S.W.3d at 134 (quoting *Cagle v. Commercial Standard Ins. Co.*, 427 S.W.2d 939, 943–44 (Tex. Civ. App.—Austin 1968, no writ))). At bottom, because the terms of the contract "actually add nothing to the scope of the insured's liability for the foundation problems," the contractual liability exclusion did not apply. *Id.*

Commentary:

This Dallas Court of Appeals decision provides a good analysis of the burden an insured (or judgment creditor) faces in establishing that "property damage" occurred during an insured's policy period. At the end of the day, that burden may not be as steep as once suspected. Beyond that, the court's decision to not apply the "contractual liability" exclusion under this set of facts is certainly a pro-insured decision, as the court recognized that the implied warranty at issue in *Castagna* is set forth in the common law and therefore not an "assumed liability" for purposes of the exclusion.

Notably, the court's analysis of the apportionment of damages issue proved ultimately to be right, as made clear by the Supreme Court of Texas's decision in *Lennar Corp. v. Markel American Insurance Co.* In that decision, discussed immediately below, the Court reached a similar conclusion.

IV. *Lennar Corp. v. Markel American Insurance Co.*, 413 S.W.3d 750 (Tex. 2013)

An important decision from the Supreme Court of Texas was issued on August 23, 2013 when the opinion in *Lennar Corp. v. Markel American Insurance Co.*, 413 WL 750 (Tex. 2013), was released. That decision touched on several major insurance coverage issues: (1) whether an insurer must be prejudiced by an insured's settlement without the insurer's consent in connection with coverage under a CGL policy; (2) whether such settlements constitute the insured's legal obligation to pay damages; and (3) whether Texas truly is the "all sums" state that insureds have contended it is for years. The Court's decision resoundingly answered "yes" to each of those questions, finding that coverage existed under Markel's CGL policy that it issued to Lennar for settlements entered into by Lennar with homeowners whose homes were damaged as a result of the installation of defective EIFS.

A. Prejudice

At the outset, the Court addressed the prejudice issue and, consistent with its prior holding in *Hernandez v. Gulf Group Lloyds*, 875 S.W.2d 691, 692–64 (Tex. 1994), held that, even when a settlement-without-consent provision is incorporated into an insuring agreement (as opposed to just being a condition), the insurer still must establish that it was prejudiced by the insured's failure to adhere to that requirement before the insurer can successfully avoid coverage. *See* Lennar, 413 S.W.3d at 754–56. Like the Court did in *Hernandez*, it grounded its holding in *Lennar* in general contract principles. That is, because Lennar's failure to adhere to the settlement-without-consent provision was not a material breach, Markel was not excused from adhering to the terms of the parties' contract unless it could show that it had been prejudiced—something Markel did not accomplish. On that point, Justice Boyd, who issued an opinion concurring in the judgment, argued that the Court should have abandoned its "contract principles" claim and grounded the decision in public policy. Notably, Justice Boyd actually would have found that no prejudice requirement existed in the first place, but he agreed that the Court's precedent, as set out in *Hernandez* and its progeny, could not be avoided. *Id.* at 759 *et seq.*

B. Legal Obligation to Pay Damages

Moreover, the Court found that the non-prejudicial settlements could be used by Lennar to establish the amount of its loss under the Markel policy. The Court said that a finding otherwise would enable Markel to "subvert the requirement that Markel show that Lennar's noncompliance was material." And, with respect to Markel's legal obligation to pay, the Court noted that the jury's finding of no prejudice could mean only one thing: "that Lennar's loss as shown by the settlement is the amount Markel is obligated to pay under the policy." *Id.* at 756. This is a significant holding in that insurers oftentimes argue that an insured cannot be legally liable unless there has been an adjudication in litigation/arbitration or a compromise settlement to which the insurer consents. Here, there was no lawsuit or arbitration and the insurer did not consent to Lennar's remediation efforts. Nevertheless, at least under these facts, the Court ruled in Lennar's favor.

C. Insurance Coverage for Lennar's Damages – An "All Sums" State

Turning to coverage for the damages incurred by Lennar, the Court emphasized that Markel agreed to pay "the total amount" of its insured's loss "because of" property damage that "occurred during the policy period." *Id.* at 757. Markel argued that Lennar could not recover anything because it failed to segregate its damages between the costs of repair of damage to the homes and the cost of locating that damage. The Supreme Court, however, disagreed, noting that the phrase "because of"—even without a broad reading of the phrase—could not be reasonably construed to preclude coverage for the cost of finding the damage so that it could be repaired. Markel conceded that each home was actually damaged, and the only way to find all the damage was to remove all the EIFS. Thus, the jury's verdict was supported by the evidence. Accordingly, in addition to the "property damage" itself, the Court held that the investigation and access costs were covered as well. *Id.*

Further, the Court noted that the damage at issue all began before or during Markel's policy period and continued thereafter. Markel, however, only wanted to pay for damage that existed during the policy period. The Court, emphasizing Markel's agreement to pay for the "total amount" of loss, noted again that all the homes at issue suffered at least some damage during the policy period and, therefore, "the policy covered Lennar's total remediation costs." *Id.* at 758. Additionally, the Court reasoned that its holding was confirmed by its prior decision in *American Physicians Insurance Exchange v. Garcia*, 876 S.W.2d 842 (Tex. 1994), where the Court found that an insured could select the policy or policies that would maximize coverage and the insurer selected could then allocate funding of indemnity among themselves pursuant to their rights of subrogation. Thus, despite Markel urging the Court to adopt a "pro rata" approach, as some courts in other jurisdictions have done recently, the Court refused to abandon its holding in *Garcia*. Likewise, the Court refused to find—as many insurers have argued—that its prior language in *Garcia* was merely dicta. As such, the Court concluded "that Markel's policy covered Lennar's entire remediation costs for damaged homes." *Lennar*, 413 S.W.3d at 758–59.

Commentary:

In sum, the Court held that: (i) Markel is responsible for the costs incurred by Lennar's voluntary remediation program even though Markel had not consented because Markel could not demonstrate that it had been prejudiced; (ii) Markel is responsible for the costs incurred to determine "property damage" as well as to repair it; and (iii) Markel is responsible for the entirety of Lennar's damages even though only a portion of the damage occurred during its policy period.[2] While the *Lennar* opinion is a terrific win for policyholders, it will be interesting to see how it is applied in future cases. By way of example, in *Lennar*, the insured asked Markel to contribute to the settlements and Markel declined. Whether the Court would have reached the same decision had Lennar simply entered into the settlement without notifying Markel is an open

[2] Approximately a month after issuing *Lennar Corp.*, the Court denied the petition for review that was filed in *VinesHerrin Custom Homes, LLC v. Great American Insurance Co.*, 357 S.W.3d 166 (Tex. App.—Dallas 2011, pet. denied), in which the court of appeals found that an insured need not present expert testimony on the precise date of injury in order to trigger the duty to indemnify where the insurer at issue provided coverage for the insured throughout the period in which damage possibly could have occurred.

question. Similarly, the Markel policy had "total loss" language—which is not found in standard CGL policies. Accordingly, it will take some time and subsequent opinions to determine the full impact of the *Lennar* opinion.

Although a significant victory, for a time, and after all of the Court's hard work in resolving many thorny issues, the ultimate holding in *Lennar* quoted above—much like the holding in *Lamar Homes, Inc. v. Mid-Continent Casualty Co.*, 242 S.W.3d 1 (Tex. 2007)—could have been rendered meaningless if the Court had decided that the "contractual liability" exclusion applies in the manner urged by Amerisure in *Ewing Construction Co., Inc. v. Amerisure Insurance Co.*, 420 S.W.3d 30 (Tex. 2014). In *Lennar*, the damages at issue were to the subject matter of the construction contract (i.e., the homes Lennar contracted to build). Under the interpretation advanced by Amerisure in *Ewing*, both a duty to defend and a duty to indemnify would be barred in their entirety by the "contractual liability" exclusion because those damages could be recovered only through causes of action sounding in contract and/or warranty. Under Ewing's interpretation, on the other hand, coverage is preserved because Lennar's liability was not in any way increased or enlarged by the terms of its contracts with the homeowners. *Lennar* is typical of most construction defect cases in this regard and helps demonstrate that applying the "contractual liability" exclusion as urged by Amerisure would eliminate insurance for otherwise covered "property damage." Thankfully, as discussed below, the Supreme Court of Texas agreed with Ewing, finding the "contractual liability" exclusion did not apply.

V. *Ewing Construction Co., Inc. v. Amerisure Insurance Co.*, 420 S.W.3d 30 (Tex. 2014)

In what had been, according to some commentators, the most watched insurance coverage case in the United States in 2013, the Supreme Court of Texas had the task of determining whether the "contractual liability" exclusion should apply to negate coverage for a general contractor where the "property damage" at issue is only to the subject matter of its construction contract. On January 17, 2014, the Court issued a unanimous opinion in favor of Ewing Construction and in favor of coverage under a standard-form CGL policy, finding that the "contractual liability" exclusion did not apply to negate coverage.

A. Background

In 2008, Ewing entered into a standard American Institute of Architects contract with a school district in the Rio Grande Valley wherein Ewing agreed to renovate and build additions to a school in Corpus Christi, including the construction of tennis courts. Shortly after their completion, however, the district complained that the courts were flaking, crumbling and cracking, making them unusable for tennis events. As a result, the district filed suit against Ewing and others under theories of negligence and breach of contract. *Id.* at *1.

Ewing tendered its defense to Amerisure, which had issued a commercial package insurance policy that included CGL coverage, but Amerisure denied coverage. Ewing filed suit, seeking a declaration that Amerisure had breached its contract by failing to defend Ewing in the underlying lawsuit and failing to indemnify it for any damages that may be awarded to the district. Amerisure did not dispute that the insuring agreement of its policy had been satisfied by the allegations in the live pleading of the underlying lawsuit, but it contended that the

"contractual liability" exclusion completely negated coverage. Ewing and Amerisure filed cross motions for summary judgment in the Southern District of Texas, where Amerisure prevailed on its argument with the district court relying in large part on the Supreme Court's earlier decision in *Gilbert Texas Construction, L.P. v. Underwriters at Lloyd's London*, 327 S.W.3d 118 (Tex. 2010). *See Ewing*, 2014 WL 185035 at *2. The crux of that court's decision was that *Gilbert* "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.* (citation omitted). Further, the court ruled that the exceptions to the exclusion did not apply.

Ewing appealed to the U.S. Fifth Circuit Court of Appeals, which initially affirmed the district court's opinion in a 2-1 decision that included a blistering dissent from Judge W. Eugene Davis. On petition for rehearing, however, the Fifth Circuit withdrew its initial opinion and certified the following two questions to the Supreme Court of Texas:

1. Does a general contractor that enters into a contract in which it agrees to perform its construction work in a good and workmanlike manner, without more specific provisions enlarging this obligation, "assume liability" for damages arising out of the contractor's defective work so as to trigger the Contractual Liability Exclusion.

2. If the answer to question one is "Yes" and the contractual liability exclusion is triggered, do the allegations in the underlying lawsuit alleging that the contractor violated its common law duty to perform the contract in a careful, workmanlike, and non-negligent manner fall within the exception to the contractual liability exclusion for "liability that would exist in the absence of contract."

Ewing Constr. Co. v. Amerisure Ins. Co., 690 F.3d 628, 633 (5th Cir.2012).

B. The "Contractual Liability" Exclusion

After addressing Texas's long-standing rules on the duty to defend—namely, the applicability of the "eight corners" rule and the necessary focus on the factual allegations of the underlying lawsuit instead of the legal theories asserted—the court turned to the allegations of the underlying lawsuit. *See Ewing*, 2014 WL 185035 at *2–*3. The Court reiterated that Ewing contracted to build the tennis courts at issue, noting that all or part of the work had been subcontracted to other parties. After the tennis courts began to flake and fall apart, the school district claimed damages under contractual and negligence theories of liability. *Id.* at *3. Importantly, the allegations under each theory were virtually the same. Additionally, the district generally alleged that Ewing breached its duty of ordinary care in performing its contract. *Id.*

Thereafter, the Court turned to the "contractual liability" exclusion relied on by Amerisure, which provided as follows:

2. Exclusions

This insurance does not apply to:

***

b. Contractual Liability

> "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. 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".

Id. at *3–*4. Noting that *Gilbert* involved the interpretation of a substantively similar exclusion and exception,[3] the Court also pointed out that *Gilbert* involved only the duty to defend, but that the duty to defend and the duty to indemnify both were at issue in *Ewing*. Nevertheless, the Court found that "*Gilbert's* interpretation of the contractual liability exclusion guides our determination." *Id.* at *4.

To briefly summarize, the Court in *Gilbert* found that the contractual liability exclusion applied to negate coverage for a breach of contract claim asserted against Gilbert by a third-party entity ("RTR") that owned property near a project Gilbert completed for the Dallas Area Rapid Transit ("DART"). That third-party property was inadvertently flooded during the course of construction, resulting in significant damages. The Court explained that Gilbert undertook two obligations in its contract with DART—one of which extended Gilbert's obligations beyond the general common law. Specifically, the Court stated as follows:

> Gilbert owed RTR a duty under general law to conduct its construction operations with ordinary care so as not to damage RTR's property. In Gilbert's contract with DART, though, it undertook a specific contractual obligation to repair or pay for damage to third-party property resulting from either (1) a failure to comply with the requirements of the contract, or (2) a failure to exercise reasonable care in performing the work. The second obligation—to exercise reasonable care—mirrored Gilbert's duty under general law principles that would have made it liable for damages it negligently caused RTR. Thus, because Gilbert's contractual liability for damages to RTR for failing to exercise ordinary care in performing its work would not have differed from its liability for damages to RTR under general principles of law—such as negligence—Gilbert did not assume liability for damages in its contract under the second obligation sufficient to trigger the policy's contractual liability exclusion.
>
> But the first obligation Gilbert assumed—to repair or pay for damage to property of ***third parties*** such as RTR "resulting from a failure to comply with the requirements of this contract"—extended "beyond Gilbert's obligations under general law." Thus, we held that RTR's breach of contract claim "was founded on an obligation or liability contractually assumed by Gilbert within the meaning of the policy exclusion." In other words, Gilbert did not contractually assume

[3] The exceptions in *Gilbert* were in the opposite order as compared to those at issue in *Ewing*.

> liability for damages within the meaning of the policy exclusion unless the liability for damages it contractually assumed was greater than the liability it would have had under general law—in Gilbert's case, negligence. We then considered whether the exception to the exclusion brought Gilbert's liability to RTR back into coverage. In doing so we recognized that the case involved "unusual circumstances" because Gilbert ordinarily could have been liable in tort for damages to RTR absent its contract, but under the facts of the case, the only basis for Gilbert's liability to RTR was RTR's claim for Gilbert's breach of the contract with DART. We held that the exception was inapplicable because Gilbert's only liability for damages was for breach of contract. Because the exclusion applied and the exception did not, there was no coverage.

Id. at *5 (emphasis added) (internal citations omitted).

With that set out, the Court turned to the facts before it and the dispute between Ewing and Amerisure. Relying on the Court's statement in *Gilbert* that the exclusion "means what it says: it 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," Amerisure argued that the exclusion applies to Ewing because "Ewing contractually undertook the obligation to construct tennis courts in a good and workmanlike manner and thereby assumed liability for damages if the construction did not meet that standard." *Id.* at *6 (quoting *Gilbert*, 327 S.W.3d at 135). On the other hand, Ewing contended that the case was different than *Gilbert* because its agreement to perform the work in a good and workmanlike manner did not enlarge its obligations beyond any general common law duty it might have. That is, unlike Gilbert's assumption of liability with respect to *third-party* property, Ewing's contract did nothing to expand its obligation beyond the requirement that it perform the contract in accordance with its terms and exercise ordinary care in doing so and, therefore, was not an "assumption of liability" within the meaning of the exclusion. *Id.* The Court said: "We agree with Ewing." *Id.*

Acknowledging and reiterating its holding in *Gilbert*, the court restated that the exclusion means what it says: "it excludes liability for damages the insured assumes by contract unless the exceptions bring the claim back into coverage." *Id.* But, also as stated in *Gilbert*, the insured has to have "assumed a liability for damages that exceeds the liability it would have under general law" or else "assumption of liability" becomes meaningless. *Id.* (citing *Am. Family Mut. Ins. Co. v. Am. Girl, Inc.*, 673 N.W.2d 65, 80–81 (Wis. 2004) ("The term 'assumption' must be interpreted to add something to the phrase 'assumption of liability in a contract or agreement.' Reading the phrase to apply to all liabilities sounding in contract renders the term 'assumption' superfluous.")). According to the Court, the allegations that Ewing did not perform its work in a good and workmanlike manner was substantively the same as the allegations that it negligently performed its work under the contract. And, as Ewing pointed out in its briefs, "it had a common law duty to perform its contact with skill and care." *Id.* As such, the Court held as follows:

> Accordingly, we conclude that a general contractor who agrees to perform its construction work in a good and workmanlike manner, without more, does not

> enlarge its duty to exercise ordinary care in fulfilling its contract, thus it does not "assume liability" for damages arising out of its defective work so as to trigger the Contractual Liability Exclusion. We answer the first [certified] question "no" and, therefore, need not answer the second [certified] question.

Id. at *7.

Having held in favor of Ewing, the Court also addressed Amerisure's rehashing of an age-old insurer argument—finding coverage in the scenario presented to the Court converts a CGL policy into a performance bond. *Id.* Having rejected the same argument in *Lamar Homes, Inc. v. Mid-Continent Casualty Co.*, 242 S.W.3d 1, 7 (Tex. 2007), the Court again disagreed with the insurer. As it explained in that earlier decision, the underlying allegations of defective construction fell within the broad coverage grant of the CGL policy, but the Court did not address whether any of the policy exclusions negated coverage. *Id.* (discussing *Lamar Homes*, 242 S.W.3d at 10). In fact, in that case, the Court noted specific business risk exclusions that may be applicable in such cases, but did not determine their applicability. *Id.* (citing *Lamar Homes*, 242 S.W.3d at 10–11). The Court concluded: "Because the policy contains exclusions that may apply to exclude coverage in a case for breach of contract due to faulty workmanship, our answer to the first certified question is not inconsistent with the view that CGL policies are not performance bonds." *Id.*

Commentary:

In another significant victory for policyholders, the Supreme Court of Texas again rejected an insurer's attempt to find that breach of contract claims are not *per se* covered by standard-form CGL policies. In doing so, the Court walked a thin line between was constitutes an "assumption of liability" as was found in *Gilbert* and what does not, but reached a clear conclusion: The mere fact that the damages at issue are only to the subject matter of the contract does not mean that coverage does not exist. On a couple of occasions, the Court noted that the *Gilbert* case involved the assumption of liability to a third party; in contrast, in *Ewing*, the parties were in direct contractual privity—a point that appears to have steered the Court's decision, at least to a certain extent. Moreover, although the Court did not abandon the "economic loss" rule, *see id.* at *6 n.7, the message from the Court was clear: when it comes to the "contractual liability" exclusion, whether a claim is actionable in tort, contract or warranty is irrelevant. Rather, what matters is whether the insured assumes liability for something other than what is already implied in every contract—the duty to perform the contract in a good and workmanlike manner. Possibly more importantly, it seems clear that the Court intended for its holding to apply to both the duty to defend and the duty to indemnify. Notably, a number of cases across Texas have been abated awaiting this opinion, so we should see, in short order, the impact of the Court's decision. Stay tuned . . .