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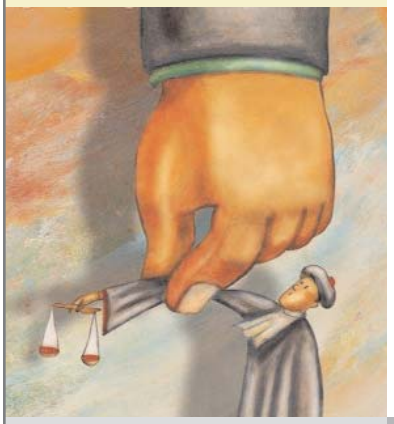
Contents



The Supreme Court Answers "No" to the Fifth Circuit's Question Regarding Coverage for Mold

On August 31, 2006, the Texas Supreme Court answered the certified question of the 5th Circuit in *Fiess v. State Farm Lloyd's* in favor of the carriers. The majority focused on well settled rules of contract interpretation and addressed the issue of whether the "ensuing loss provision contained in Section I-Exclusions, part 1(f) of the Homeowner's Form B (HO-B) policy when read in conjunction with the remainder of the policy, provides coverage for mold contamination caused by water damage that is otherwise covered by the policy." Finding the policy language clear and unequivocal, Justice Brister, speaking for the majority held, "In this case, it is hard to find any ambiguity in the ordinary meaning of 'We do not cover loss caused by mold.'"

The court relied upon *Lambros v. Standard Fire Ins.*, 530 S.W.2d 138 (Tex. Civ. App. – San Antonio 1975, writ ref'd) in construing the "ensuing loss" provision in the policy. Noting that although the policy had changed, the court found the "ensuing loss" language in *Lambros* was indistinguishable from the language in the policy at issue. The court noted that not every instance of mold would give rise to coverage as it would convert the homeowner's insurance policy into a maintenance policy and effectively obliterate twenty-two exclusions.

The court further noted that mold itself is not water damage as that term is used in the policy. The court adopted Justice's Friendly's reasoning in *Aetna Cas. & Sur. Co. v. Yates,* 344 F.2d 939, 941 (5th Cir. 1965) as to what the phrase "caused by water damage" would mean. "We do not think that a single phenomenon that is clearly an excluded risk under the policy was meant to become compensable because in a philosophical sense it can also be classified as water damage; it would not be easy to find a case of rot or dampness of atmosphere not equally subject to that label and the exclusion would become practically meaningless. In our case the rot may have ensued from water but not from water damage, and the damage ensuing from rot was not the damage from the direct intrusion of water conveyed by the phrase water damage." *Aetna*, at 941. The court noted, without deciding the extent of the phrase, that "water damage" must refer to something more than every tiny water leak or seep.

See *Fiess Ruling* on page 7

Prompt Payment Penalties: Waiting on Pins and Needles

Long after oral argument and in the midst of continuous debate, the Texas Supreme Court continues to mull over whether an insurer who wrongfully refuses to defend a third-party claim or pay defense costs can be held liable for statutory penalties under the Insurance Code's prompt payment of claims provisions (TEX. INS. CODE ANN. §§ 542.051-.061; formerly TEX. INS. CODE ANN. art. 21.55). *See Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 428 F.3d 193 (5th Cir. 2005)(certified question of applicability of 21.55 to Texas Supreme Court). Despite the fact that the question looms in the chambers of Texas' highest court, a few courts have recently issued rulings in opposite directions, while at least one federal court has openly refused to rule on the issue, pending word from the Supreme Court. The split in authority is centered on the application of key terms in the prompt payment statute, such as "claim."

Texas appellate courts, for the most part, have consistently held that article 21.55 does not apply to third-party liability claims. On July 6, 2006, the Houston Court of Appeals joined the Dallas Court of Appeals and other Texas appellate courts in holding that a demand for a defense under a liability policy is not a first-party claim, refusing to apply the prompt payment statute. *See Pine Oak Builders, Inc. v. Great American Lloyds Insurance Co.*, No. 14-05-00487-CV, __ S.W.3d __, 2006 WL 1892669 (Tex. App. – Houston [14th Dist.] July 6, 2006, no pet.). The Houston court adopted the reasoning of the Dallas court in *TIG Insurance Co. v. Dallas Basketball, Ltd.*, 129 S.W.3d 232 (Tex. App. – Dallas 2004, pet. denied), and held that the structure of article 21.55 presumes a tangible loss has been suffered by the insured for which it seeks payment from its insurer. The Houston court further stated that attempting to apply the statute to a claim for a defense is unworkable and goes against the legislative intent. The court concluded that when an insurer refuses to provide a defense, the insured's claim for reimbursement is not a claim under the insurance policy, but is a common law claim for breach of the policy; thus the prompt payment statute does not apply.

On the other end of the pendulum, a Houston magistrate judge presiding over a case in the Southern District followed the direction of several federal district courts in Texas that have departed from the Texas state courts and generally held that a failure to promptly pay defense costs can trigger statutory penalties. *See HCC Employer Serv., Inc. v. Westchester County Surplus Lines Ins. Co.*, 2006 WL 1663343 (S.D. Tex. June 5, 2006). In *HCC*, the insurer refused to indemnify its insured for defense costs incurred and other amounts paid in connection with a previous settlement agreement. In a Memorandum Opinion dated June 5, 2006, Magistrate Judge Nancy Johnson held that where the policy itself does not obligate the insurer to provide a defense, the prompt payment of claims statute applies to claims for reimbursement of defense costs which fall within the policy's definition of "Loss." The court analyzed the facts of the case and the policy, and expressly stated that the case presented distinct issues from those certified to the Supreme Court in *Lamar Homes*. The court concluded that based on the policy language and facts, the statutory prompt payment penalties attached both to the insured's indemnity claims for defense costs and amounts paid by the insured to resolve the third-party claim.

> " The court...expressly stated that the case presented distinct issues from those certified to the Supreme Court in *Lamar Homes*."

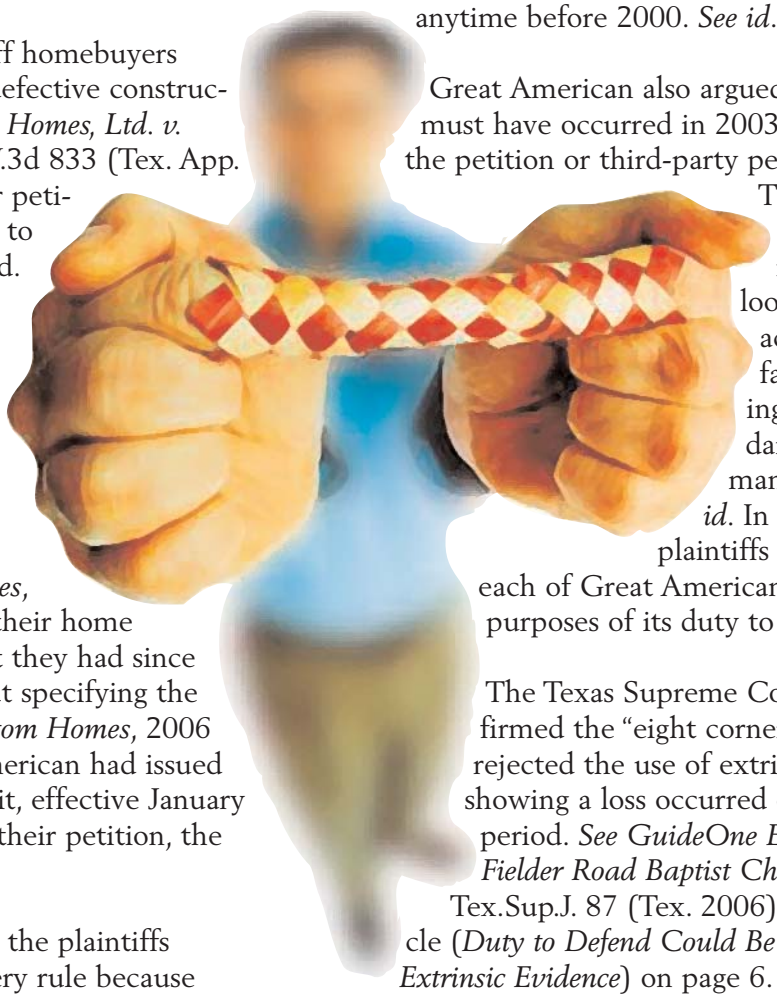
In the wake of these two holdings, a magistrate from the Western District of Texas issued a Memorandum Order and Opinion on July 18, 2006 in a coverage action as to all issues, but abstained from ruling on the issue of whether the insurer violated article 21.55 by failing to tender a defense or settle the underlying suit. *See Federal Ins. Co. v. Infoglide Corp.*, 2006 WL 2050694 (W.D. Tex. July 18, 2006). The court held that, although some of the claims at issue are best characterized as first-party claims, other courts have treated a claim for reimbursement of defense and settlement costs as a third-party claim for which no relief is available under article 21.55. Because the issue is still in dispute, and is pending before the Supreme Court, the court refused to try to predict the outcome of that case and refused to resolve the 21.55 claim on this ground. The court left open the issue, "in the hopes that a definitive answer will be forthcoming from the Texas Supreme Court."

See *Uncertainty re: Prompt Payment* on page 6

VAGUE FACTS AS TO DATE OF OCCURRENCE OR DAMAGE MAY TRIGGER MULTIPLE POLICIES: *SUMMIT CUSTOM HOMES V. GREAT AMERICAN LLOYDS INS. CO.*

On July 18, 2006, the Dallas Court of Appeals issued an opinion in *Summit Custom Homes v. Great American Lloyds Ins. Co.*, 2006 Tex. App. LEXIS 6143 (Tex. App. -- Dallas, no pet.) reaffirming its holding in *Gehan Homes, Ltd.* that an insurer's policy is triggered -- and an insurer owes a duty to defend -- if it cannot conclusively establish through the "eight corners" rule that the loss did not occur during the policy period. As a result, a plaintiff may plead vague or no facts regarding the date of "occurrence" or damage and successfully trigger multiple policies.

In *Gehan Homes, Ltd.*, the plaintiff homebuyers filed suit against Gehan alleging defective construction of their residence. *See Gehan Homes, Ltd. v. Employers Mut. Cas. Co.*, 146 S.W.3d 833 (Tex. App. -- Dallas 2004, pet. filed). In their petition, however, the plaintiffs failed to specify when the damage occurred. In liberally construing the plaintiffs' pleadings against Gehan, the court concluded Employers could not establish as a matter of law that there was no allegation of a potential occurrence within the policy period. *See id.* at 844.



Similarly, in *Summit Custom Homes*, the plaintiff homebuyers alleged their home was constructed in 1996, and that they had since suffered property damage, without specifying the dates of damage. *See Summit Custom Homes*, 2006 Tex. App. LEXIS 6143. Great American had issued general liability policies to Summit, effective January 15, 1996 to January 15, 2000. In their petition, the plaintiffs alleged:

> Each and every claim made by the plaintiffs herein is subject to the discovery rule because the defects of which plaintiffs complain were latent and/or otherwise undiscoverable. The defects caused damage within the wall cavity which is not readily apparent to one examining the exterior of the EIFS surface. As a result, the named plaintiffs would not, in the exercise of reasonable diligence, immediately perceive, or discover the defects complained of herein.

Great American argued that because the plaintiffs pleaded the discovery rule, in effect stating they only discovered the defects within the applicable statute of limitations, which would have been around 2000 and suit was filed in 2003, the plaintiffs could not have discovered damage in 1996 and within the earliest policy period. *See id.* The court, however, applied the "eights corners" rule, finding it could not determine if the 1996-2000 policies applied, and held that Great American failed to establish as a matter of law that the damages did not manifest during 1996 or anytime before 2000. *See id.*

Great American also argued the damages must have occurred in 2003 or 2004 when the petition or third-party petitions were filed. The court held that this argument also overlooked the fact that, according to the facts in the pleading, although vague, damage could have manifested earlier. *See id.* In essence, the plaintiffs had triggered each of Great American's policies for purposes of its duty to defend.

The Texas Supreme Court recently reaffirmed the "eight corners" rule and rejected the use of extrinsic evidence showing a loss occurred outside the policy period. *See GuideOne Elite Ins. Co. v. Fielder Road Baptist Church*, 49 Tex.Sup.J. 87 (Tex. 2006) and related article (*Duty to Defend Could Be Triggered by Extrinsic Evidence*) on page 6. Therefore, this holding, in conjunction with the *Summit Custom Homes* decision, requires insurers confronted with vague pleadings regarding dates of loss to potentially defend under each implicated policy.

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Recent Developments in Homeowners Insurance

The appellate courts recently addressed two issues in the homeowner arena. The 14th Court of Appeals recently provided guidance on the meaning of the "limit of liability" provisions under a standard homeowners Form B policy. In C*oats v. Farmer's Insurance Exchange*, 2006 WL 1765925 (Tex. App. — Houston [14th Dist.] June 29, 2006), the Court addressed the "insurable interest and limit of liability" provision as well as the "loss settlement" provision in a Standard Form B Homeowners Policy. Previously, no state court has addressed an insurer's limit of liability under a homeowner's policy.

The Coats suffered three consecutive losses to their residence for which they made claims. The first claim occurred on or about April 18, 2001 for hail and water damage to the roof. The second claim occurred in June 2001 when the Coats filed a claim for water and roof damage to their home as a result of tropical storm Allison. In its investigation of that loss, Farmers discovered several water sources which had caused damage to the home including a leak in the air conditioning and heating system, several leaks in the roof and a hot tub leak. In March 2002, Farmers determined that the Coats residence was a total loss and paid the policy limit for dwelling and ALE. In July 2002, the Coats filed another claim alleging an HVAC overflow had caused water and mold damage. Farmers investigated that claim and determined the damage allegedly caused by the HVAC overflow was considered when the appellants received the policy limits in March. In December 2002, the Coats sued Farmers for nonpayment of the HVAC claim and pursued causes of action for breach of contract, negligence, gross negligence, violations of the Texas Deceptive Trade Practices Act, violations of Articles 21.21 and 21.55 of the Insurance Code and Breach of the duty of good faith and fair dealing. Farmers filed a summary judgment motion contending that there was no genuine issue of material fact because Farmers paid appellant the policy limits. The Coats contended that they were entitled to receive a sum not to exceed the policy limits for each source of damage. The trial court granted summary judgment in favor of Farmers.

The Coats contended the phrase "any one loss" that appeared under the heading entitled "Insurable Interest and Limit of Liability" created an ambiguity or expressly required Farmers to pay an amount not to exceed the declared limit of liability for each loss sustained during the policy period. The Coats further argued that the omission of the reinstatement clauses for losses caused by perils other than fire supported their contention that the policy was ambiguous or that the carrier expressly agreed to remit policy limits for each loss other than fire, regardless of the number of losses during the policy period. Farmers contended no ambiguity existed because the policy, when read as a whole, clearly limited a carrier's liability to the policy limits.

The court concluded that there was no ambiguity in the policy provisions and further concluded that the policy proceeds should be applied to indemnify the insured up to the amount of the policy, fulfilling the objective that the insured should neither reap economic gain, nor incur a loss, if adequately insured. *Coats* at p. 5

The policy unambiguously entitled appellants to the smaller of two amounts: (1) the limit of liability, or (2) the cost to repair or replace the home. It is undisputed that Farmers paid the limit of liability; therefore Farmers fulfilled its contractual obligation by paying the declared limit of liability. *Ibid* The court also noted that three federal district courts in Texas, applying Texas law had found that the limit of liability was absolute.

This opinion is the first state court opinion on this issue and clarifies this issue for both carriers and policy holders. Despite recent changes to most homeowner policies substantially curtailing or even eliminating coverage for mold, the limit of liability provisions have remained substantially unchanged.

The Dallas Court of Appeals recently re-visited the appraisal provision in the Texas Homeowner's Insurance Policy. Again, despite changes to most homeowner policies in Texas, the appraisal provisions have remained largely unchanged. In *Becky Ann Johnson v. State Farm Lloyds*, 2006 WL 2053472 (Tex. App. — Dallas, July 25, 2006) a dispute arose after the roof of Ms. Johnson's home was damaged by hail in April 2003. State Farm inspected the property and concluded only the ridge line of Johnson's roof had been damaged by hail and estimated the repairs at $499.50 which was less than the deductible. At Johnson's request, State Farm conducted a second inspection. The result was the same. Johnson argued

that the entire roof needed to be replaced and submitted an estimate for the repairs over $6,400.00. She also hired an attorney who wrote State Farm demanding it submit to the appraisal process pursuant to the appraisal clause of the policy. State Farm declined stating the party's disagreement about the extent of hail damage was a coverage issue that could not be decided by appraisal. Johnson filed a declaratory judgment action seeking to compel State Farm to submit an appraisal pursuant to the policy. Both parties moved for summary judgment. The trial court granted State Farm's motion and denied Johnson's motion. The Dallas Court of Appeals concluded that the dispute between Johnson and State Farm concerned the amount of loss and the appraisal clause applied. They reversed the trial court order granting State Farm's summary judgment and rendered judgment granting Johnson's motion compelling the appraisal.

On appeal, Johnson contended the appraisal clause required State Farm to submit to the appraisal process because the dispute concerned the amount of loss sustained as a result of hail damage, not whether the hail damage was covered by the policy. Johnson argued that the amount of loss included a dispute over the extent of the damage as well as a determination of what it would cost to fix the damage.

State Farm contended that it did not have to submit to the appraisal process unless the parties first agreed on causation, coverage and liability. It further contended that whether the hail damaged only the ridge line of the roof as it contended or the entire roof as Johnson contended was a causation, coverage and liability issue, not an issue concerning the amount of loss. State Farm argued that deciding the extent of the loss involved decisions about causation, coverage and liability that cannot be made pursuant to the appraisal clause. State Farm's interpretation of the appraisal clause was that it and Johnson must first agree on which specific shingles were damaged and then, only if there is a dispute over the cost to repair those specific shingles, could Johnson compel State Farm to submit to an appraisal.

The court relied instead upon *Lundstrom v. United Services Automobile Association* – CIC, 192 S.W.3d 78 (Tex. App. — Houston [14th Dist.] 2006, pet. filed) in which the insured's home was damaged by multiple water leaks. In determining that appraisal was appropriate in this the insurer in *Lundstrom* agreed to cover the losses caused by the initial water leak and asked the appraisers to determine the amount of that loss. In doing so, the appraisers in *Lundstrom* had to determine which damages were caused by the initial leak and distinguish those damages from the damages that occurred later due to the other causes. The court concluded that the appraisers in *Lundstrom* were not deciding a causation issue, but rather were deciding an issue concerning the amount of loss.

The Dallas Court of Appeals held that while *Wells v. American States*, 919 S.W.2d 679 (Tex. App. — Dallas 1996, writ denied) limits the appraiser's authority, it does not prevent appraisers from making decisions about the extent of damage. "If the parties had to first agree on which specific shingles were damaged and approached every disagreement on the extent of damage as a causation, coverage or liability issue, either party could defeat the other party's request for an appraisal by labeling the disagreement as a coverage dispute. Instead, as the process is designed, once it is determined that there is a covered loss and a dispute about the amount of that loss, the appraisal process determines the amount that should be paid because of loss from a covered peril. The process necessarily requires the appraiser to access the extent of the damage and exclude payment for causes not covered." *Johnson* at p.5. The court further noted that simply because appraisers were differentiating between hail damage and normal wear and tear did not mean that the appraisers were making coverage decisions. The court went on to note that because the parties had agreed that the covered properties sustained damage from a covered peril, but failed to agree on the amount of loss, the appraisal clause applied. *Ibid*.

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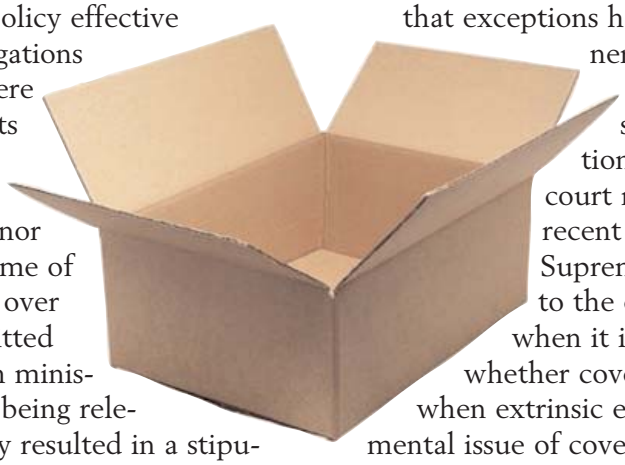
DUTY TO DEFEND COULD BE TRIGGERED BY EXTRINSIC EVIDENCE: *GUIDEONE ELITE INS. CO. V. FIELDER ROAD BAPTIST CHURCH*

The Texas Supreme Court recently addressed whether there is an extrinsic evidence exception to the eight corners rule. In other words, the court determined whether the duty to defend could be triggered by evidence outside the pleadings themselves. Although the Fifth Circuit has held that there are very narrow exceptions to the eight corners rule, the Texas Supreme Court has never addressed this issue.

In *GuideOne Elite Ins. Co. v. Fielder Road Baptist Church*, the carrier issued a policy effective 3/31/93 to 3/31/94. The allegations against the insured church were that a youth minister under its direct supervision and control, employed from 1992-1994, sexually molested a minor church member during the time of employment. The trial court, over the church's objection, permitted discovery regarding the youth minister's dates of employment as being relevant. The discovery ultimately resulted in a stipulation between the carrier and the church that the youth minister commenced work as a part-time intern on 11/14/91, became a part-time associate on 1/1/92, left the church's employment on 12/15/92, and never served as, nor was he ever authorized to act as an officer or director of the church. Relying on this stipulation between the parties, the trial court entered a judgment that the carrier owed no duty to defend, and the church appealed. The court of appeals held that the eight corners rule must be strictly applied and reversed the judgment in favor of the carrier.



At the supreme court, the carrier argued: (1) the extrinsic evidence primarily related to coverage rather than the merits of the underlying claim; (2) the extrinsic evidence was necessary because the allegations alone were insufficient to determine the duty to defend; and (3) if the evidence related to both coverage and liability, the court should make an exception to the eight corners rules for such mixed/overlapping evidence.

Notably, the Supreme Court specifically recognized that exceptions have been made to the eight corners rule and did not imply or hold that it disagreed that particular situations may require consideration of extrinsic evidence. In fact, the court recognized the Fifth Circuit's recent pronouncement that if the Texas Supreme Court recognized an exception to the eight corners rule, it would be when it is initially impossible to discern whether coverage is potentially implicated and when extrinsic evidence goes solely to a fundamental issue of coverage which does not overlap with the merits of the underlying case or engage in the truth or falsity of any facts alleged in the underlying lawsuit. Because the youth minister's dates of employment potentially affected both liability issues and coverage issues, and specifically contradicted pleaded facts, the Supreme Court held that the factual scenario did not present a situation requiring an exception to the eight corners rule.

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UNCERTAINTY RE: PROMPT PAYMENT (CONT'D FROM PAGE 2)

Clearly, these cases add more fuel to the fire. The recent decisions continue to cause further confusion to insureds, insurers and commentators, and heighten emotions and economic concerns. How do we evaluate and calculate the potential exposure in a case when the penalty is *possibly* 18% interest? Is interest still accruing if the judge puts off a ruling in hopes of guidance from the Supreme Court? If the statute ultimately applies to third-party claims, will it apply to claims for indemnity or reimbursement of defense costs, or both? These are all logical questions which the Supreme Court may or may not answer in *Lamar Homes*.

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Fiess Ruling (cont'd from Page 1)

The court's ruling appears to eliminate mold coverage from the HO-B policy. The Court emphasized that the rules for interpreting an insurance policy do not change simply because potentially harsh circumstances may exist. The court was not persuaded by the Texas Department of Insurance's interpretation of the policy. Rather, "if potential branches of the Texas government decide that mold should be covered in the Texas Insurance policies, they have tools at their disposal to do so; Texas courts must stick to what those policies say and cannot adopt a different rule when a 'crisis' arises." What impact this case has on insurance policies in Texas in the future remains to be seen, but for those few remaining mold claims and lawsuits, it is clear, the end is near.

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Thompson Coe Hosts Sixth Annual Seminar on Texas Insurance Law Developments

On October 12, 2006, Thompson Coe will host the *Sixth Annual Seminar on Texas Insurance Law Developments* in Dallas, Texas. This seminar is provided as a free service to valued clients and friends of the firm. The following topics will be discussed:

The When, Where & Whys of Litigation Coverage: Strategies for Declaratory Judgment Actions

Property Insurance Issues After a Hurricane Loss

What is Covered and How Much Do You Owe: An Update on Personal Lines Coverage

Conflicts and the Tripartite Relationship: Analysis of a Defense Lawyer's Obligations and a Carrier's Duties

Allocation of Coverage and its Effects on Carriers and Claimants

Legal Storm Clouds Brewing? A Preview of the 2007 Texas Legislative Session

Common Perils and Engineering Investigations

Are Eight Corners Enough? The Use of Extrinsic Evidence in Determining an Insurer's Duty to Defend

Protecting Your Insured from Enforcement of a Judgment During an Appeal

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What Do Twelve Ordinary People Think? The Art of Picking the Jury

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The seminar will take place at the historic Arlington Hall at Lee Park, 3333 Lee Parkway, Dallas, Texas. Lunch will be provided and there will be a cocktail reception immediately following the seminar.

Seating is limited. To RSVP in Advance: rsvp@thompsoncoe.com or 214.880.2593 - please provide your name, company name, and a telephone number where you can be reached.

The full agenda and additional information about the seminar is available on-line at www.thompsoncoe.com.

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