CONSTRUCTION DEFECT COVERAGE: WHAT'S COVERED, WHAT'S NOT?

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CONSTRUCTION-DEFECT COVERAGE: WHAT'S COVERED, WHAT'S NOT?[1]

I. INTRODUCTION

The recent housing boom has been a godsend to the construction industry. On the other hand, the resulting avalanche of faulty-construction claims has led to a great deal of litigation concerning the faulty construction, including EIFS[2] and mold claims.[3] This in turn has led to coverage litigation related to those claims in the Texas Supreme Court[4] and other courts.[5]

Many insurance companies and courts argue that a CGL policy is not intended to cover risks the insured assumes merely by engaging in business,[6] and that coverage is not available for

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[1] This paper relies heavily on materials from *Coverage for Construction Defect Cases Under General Liability Policies* by Shelley Rogers of Sheehy, Serpe & Ware, PC, Houston, Texas; *The Rising Price of Declining Coverage in the Construction Industry: Coverage for Construction Claims from the Policyholder's Perspective* by J. James Cooper of Gardere, Wynne, & Sewell, LLP, Houston, Texas; and *Clarifying the Confusion Over the "Business Risk" Exclusions and Other Related Construction Defect Topics* by Rebecca DiMasi of Van Osselaer, Cronin & Buchanan, LLP, Austin, Texas. I thank and acknowledge the help of those authors. Any mistakes herein, however, are my own and are not due to them.

[2] Exterior Insulation and Finish System ("EIFS") is a synthetic stucco. It was applied to many homes and is claimed to trap water, causing damages such as wood rot, damage to housing structures, features and interiors, and termite infestation.

[3] Although beyond the scope of this paper, an adjuster dealing with a Texas construction claim should be aware of the widespread use and enforcement of arbitration clauses in construction contracts, particularly between a consumer home purchaser and the developer. For claims involving buildings that are residential in nature, the Texas Residential Construction Liability Act, Tex. Prop. Code. Ann. Ch. 27 and the Texas Residential Construction Commission Act, Tex. Prop. Code Ann. Ch. 401 *et seq.*, are widely seen as pro-builder (and even onerously anti-consumer), and should be familiar to an adjuster dealing with such a claim. They include many limitations of liability for a builder as well as provisions for mandatory notice of claim and opportunity to repair, mandatory mediation, and non-binding, but rebuttably presumptive, inspections and findings by a state-certified inspector. If a builder does not appear to be aware of, or is not taking full advantage of, its arbitration rights or rights under the acts, an adjuster should be prepared to remedy that omission.

[4] The Texas Supreme Court currently has either accepted for review or has before it for consideration of review no less than six construction-coverage related cases: *Lamar Homes, Inc. v. Mid-Continent Casualty Company*, 428 F.3d 193 (5th Cir. 2005) (certified question accepted Nov. 4, 2005 – Texas Supreme Court Docket No. 05-0832, oral argument on February 14, 2006); *Gehan Homes, Ltd. v. Employers Mutual Cas. Co.*, 146 S.W.3d 833 (Tex. App. – Dallas 2004, pet. filed Jan. 5, 2005, briefing on merits requested June 6, 2005); *Archon Inv., Inc. v. Great American Lloyds Ins. Co.*, 174 S.W.3d 334, (Tex. App. – Houston [1st Dist.] 2005, pet. filed Nov. 17, 2005, briefing on merits requested April 25, 2006); *Grimes Const., Inc. v. Great American Lloyds Ins. Co.*, 188 S.W.3d 805, 813 (Tex. App. – Fort Worth 2006, pet. for review filed May 11, 2006, briefing on merits requested Oct. 17, 2006); *Lennar Corp. v. Great Am. Ins. Co.*, 200 S.W.3d 651 (Tex. App. – Houston [14th Dist.] 2006, pet. for review filed May 11, 2006); and *Pine Oak Builders, Inc. v. Great American Lloyds Ins. Co.*, ___ S.W. ___, 2006 WL 1892669, Case No. 14-05-00487-CV (Tex. App. – Houston [14th Dist.] July 6, 2006, pet. requested Oct. 4, 2006).

[5] Some of the more important examples are discussed in this paper.

[6] *See Pine Oak Builders, Inc.*, 2006 WL 1892669 at *3 (observing coverage for construction defect claims is a contentious issue in state and nationally); Mary E. Borja, *Recent Developments in Key Insurance Exclusions for Construction Insureds – EIFS, Mold and Professional Liability*, Real Estate Fin. J., Summer 2005 at 61.

the cost of repairing or replacing the insured's defective work.[7] In fact, it is not unusual to hear from insurance companies that "CGL Policies are not performance bonds."[8] The reality, however, is that courts do not accept such clichés on their face and are instead looking to the actual policy language and rules for construction of policies to determine whether either a duty to defend or indemnify exists. An adjuster who relies on clichés rather than solid analysis of the claim in connection with actual policy language and legal interpretation is placing her company at risk, not just for a policy claim, but possibly for extra-contractual damages.[9]

In determining a coverage claim, a claims adjuster must first determine whether there is coverage generally under the policy insuring agreement, and then, if there is coverage or potential coverage, whether an exclusion applies. The facts and analysis applicable to claims determination change greatly depending on whether you are determining if your company has a duty to defend the alleged insured or a duty to indemnify, which are distinct and separate duties.[10] The distinction is beyond the scope of this paper and is being discussed by other speakers. In general, however, an insurance company must analyze a duty to defend within the eight corners of the plaintiff's complaint or petition and the insurance policy.[11] The allegations of the claimant's pleadings are compared to the policy language, and if the allegations, taken as true, fall within coverage, the insurer must defend.[12] If defense coverage exists for any portion of the suit, the insurer must defend the entire suit.[13]

If there is a duty to defend, a ruling on the duty to indemnify is premature,[14] and is instead to be determined based on the facts actually developed at the trial of the underlying claim.[15] But if there is no duty to defend, there is no duty to indemnify.[16]

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[7] *See Gulf Miss. Marine Corp. v. George Engine Co.*, 697 F.2d 668, 670 (5th Cir. 1983) (applying Louisiana law).

[8] *See Lamar Homes, Inc.*, 428 F.3d at 198; *Gaylord Chem. Corp. v. Propump*, 753 So.2d 349, 353 n.5 (La. Ct. App. 2000).

[9] Extra-contractual claims are beyond the scope of this paper, but may include, for example, claims under Tex. Ins. Code Ann. §542.051 *et seq.* (recodified version of former Tex. Ins. Code Art. 21.55). Note that the applicability of §542.051 of the Texas Insurance Code to third-party liability claims and coverage issues concerning CGL policies is hotly debated with major court splits at this time.

[10] *Farmers Texas County Mut. Ins. Co. v. Griffin*, 955 S.W.2d 81, 82 (Tex. 1997).

[11] *King v. Dallas Fire Ins. Co.*, 85 S.W.3d 185, 187 (Tex. 2002).

[12] *Id. National Union Fire Ins. Co. v. Merchants Fast Motor Lines*, 939 S.W.2d 139, 141 (Tex. 1997).

[13] *Stumph v. Dallas Fire Ins. Co.*, 34 S.W.3d 722, 728 (Tex. App. – Austin 2000, no pet.).

[14] *Nationwide Prop. & Cas. Ins. Co. v. McFarland*, 887 S.W.2d 487, 491 (Tex. App. – Dallas 1994, writ denied).

[15] *Archon Investments*, 174 S.W.3d at 343.

[16] *Griffin*, 955 S.W.2d at 82.

II. IS THERE COVERAGE IN GENERAL?: THE INSURING PROVISIONS AND THEIR BASIC COVERAGE ISSUES

Each insurance policy stands on its own and must be interpreted that way. On the other hand, many CGL policies are either written on or borrow heavily from copyrighted forms issued by the Insurance Services Office, Inc. ("ISO"). Accordingly, I will use some general form ISO language or paraphrases of them in discussing both the insuring provisions as well as important exclusions. Many of the court rulings concerning them will have bearing on similar form language, but you should be aware of any differences in determining your company's position on coverage.

In general, in determining under such terms whether there is coverage under a CGL policy for a construction-defect case before application of exclusions in a defective construction, you must ask three questions:[17]

1. Was there an "occurrence" as defined in the policy?

2. Was the occurrence "during the policy period."[18]

3. Were the claimed damages sums that the insured was legally obligated to pay because of "property damage?"

Typical relevant policy language regarding these questions from 1998 or later ISO forms is:

- **The insuring agreement:**

  a. We [the insurer] will pay those sums that the insured becomes legally obligated to pay as damages because of "bodily injury" or "property damage" to which this insurance applies. We will have the right and duty to defend the insured against any "suit" seeking those damages.

  b. This insurance applies to "bodily injury" and "property damage" only if

[17] Other questions such as "Is the Claimant an Insured?" that are always potentially at issue must also be answered.

[18] This is commonly referred to as the "trigger" provision. Depending on the policy it may actually be in the insuring agreement, definition of occurrence, or even the definition of "property damage" or "bodily injury." For conceptual reasons, I am discussing it separately from the other issues, but it must be read in the context of its wording and location in each particular policy.

(1) The "bodily injury" or "property damage" is caused by an "occurrence" that takes place in the "coverage territory"; and

(2) The "bodily injury" or "property damage" occurs during the policy period; and

(3) (2001 edition and later) Prior to the policy period, no insured listed under Paragraph 1 of Section II – Who Is An Insured and no "employee" authorized by you to give or receive notice of an "occurrence" or claim, knew that the "bodily injury" or "property damage" had occurred, in whole or in part. If such a listed insured or authorized "employee" knew, prior to the policy period, that the "bodily injury" or "property damage" occurred, then any continuation, change or resumption of such "bodily injury" or "property damage" during or after the policy period will be deemed to have been known prior to the policy period.

- **The "Separation of Insureds" clause:**

  Except with respect to the Limits of Insurance, and any rights or duties specifically assigned in this Coverage Part to the first Named Insured, this insurance applies:

  a. As if each Named Insured were the only Named Insured; and

  b. Separately to each insured against whom claim is made or suit is brought.

- **"Occurrence" defined:**

  . . . an accident, including continuous or repeated exposure to substantially the same general harmful conditions.

- **"Property Damage" defined:**

  a. Physical injury to tangible property, including all resulting loss of use of that property. All such loss of use shall be deemed to occur at the time of the physical injury that caused it; or

  c. Loss of use of tangible property that is not physically injured. All such loss of use shall be deemed to occur at the time of the "occurrence" that caused it.

A. Is defective construction an "occurrence?"

Questions of whether defective construction is an "occurrence" and related issues are clearly already before the Texas Supreme Court.[19] Many of the underlying cases clearly state "yes,"[20] while others say "no."[21] But the one case the Texas Supreme Court has actually accepted for review because of the broad confusion in Texas law, *Lamar Homes*,[22] simply notes the different lines of authority and leaves the decision to the Texas Supreme Court. Before reviewing those cases briefly, you should be aware of the relevant Texas Supreme Court cases that are relied upon by the pending cases in their differing results.

1. The Texas Supreme Court's two-part analysis: intent plus foreseeable effect as determined from the viewpoint of the insured.[23]

The CGL policy defines "occurrence" as an "accident, including continuous or repeated exposure to substantially the same general harmful conditions," but it does not define "accident." The most recent opinions from the Texas Supreme Court regarding what is an "accident" in a liability insurance context are *Trinity Universal Inc. Co. v. Cowan*, 945 S.W.2d 819 (Tex. 1997) (homeowner's liability policy) and *Mid-Century Ins. Co. v. Lindsey*, 997 S.W.2d 193 (Tex. 1999) (auto liability policy).

In *Cowan*, the court considered whether the acts of a photo shop clerk in showing a customer's "somewhat revealing" pictures to his friends (without the customer's permission) was an "accident" and therefore an "occurrence" under the clerk's parents' homeowner's liability insurance.[24] It ruled that the clerk's actions were an "intentional tort,"[25] and found that there was no "accident."[26]

Although construction-defect cases do not generally involve intentional torts, *Cowan* is relevant for two reasons. The court quoted extensively from its prior opinion in a life insurance

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[19] *See* footnote 5 *supra*.

[20] *Lennar Corp.*, 200 S.W.3d 651.; *Archon Inv.*, 174 S.W.3d 334; *Gehan Homes*, 146 S.W.3d 833; *Pine Oak Builders*, 2006 WL 1892669.

[21] *Grimes Const.*, 188 S.W.3d 805.

[22] *Lamar Homes*, 428 F.3d 193.

[23] Many policies also have an intentional act exclusion, which appears to likewise focus on the effect of the insured's act and not the effect itself. *Gulf Chem. & Metallurgical Corp. v. Associated Metals & Minerals Corp.*, 1 F.3d 365, 370 (5th Cir. 1993). The language of the broader "knowledge" of injury language contained in the 2001 and later ISO forms has not yet been broadly interpreted by the Texas courts. *See*, §II.B.2 *infra*.

[24] *Cowan*, 945 S.W.2d at 820-821.

[25] *Id.* at 820.

[26] *Id.* at 828.

case, *Heyward*, including language that "an effect that 'cannot be reasonably anticipated from the use of [the means that produced it], an effect which the actor did not intend to produce and which *he cannot be charged with the design of producing*, is produced by accidental means.'"[27] This suggests that conduct that does not necessarily rise to the level of culpability of an intentional tort may not be an "accident" in certain circumstances. The court also rejected the insurer's argument that if an actor intended to engage in the conduct that gave rise to the injury, there could never be an "accident," thereby suggesting that even intentional conduct can be an "accident" under certain circumstances.[28]

In *Lindsey*, the court reviewed whether a little boy's act of climbing through a pick-up truck cab's back window in order to retrieve his clothing, thereby causing a shotgun on a gun rack to discharge and injury a man sitting in his mother's car parked alongside the pick-up, was an "accident" under the uninsured/underinsured motorists' provisions of the victim's mother's auto liability policy, which provided coverage for auto "accidents."[29] Noting that the policy did not define "accident," the court observed that it had previously held in *Heyward* (the life insurance case) that "an injury is accidental if 'from the viewpoint of the insured, [it is] not the natural and probable consequence of the action or occurrence which produced the injury; or in other words, if the injury could not reasonably be anticipated by the insured, or would not ordinarily follow from the action or occurrence which caused the injury.'"[30]

The court ruled that an injury caused by voluntary and intentional conduct is not an accident just because the result or injury may not have been unexpected, unforeseen, and unintended and that the mere fact that an actor intended to engage in the conduct that gave rise to the injury would not mean that the injury was not accidental.[31] "Rather, both the actor's intent and the reasonably foreseeable effect of his conduct bear on the determination of whether an occurrence is accidental." So, *Lindsey* informs us that two factors determine whether damages are caused by an "accident" and therefore an "occurrence:" (1) the actor's intent, and (2) the foreseeable effect of his conduct.

Whether an act and its consequences are an "occurrence" is determined from the standpoint of the insured claiming coverage, not the person who performed the act. *King v. Dallas Fire Ins. Co.*, 85 S.W.3d 185, 191-192 (Tex. 2002). Dallas Fire's insured, King, was sued by a Jankowiak, who claimed that one of King's employees, Lopez, had assaulted Jankowiak at a construction worksite. Jankowiak alleged that King was liable on the basis of *respondeat superior* and also that King was negligent in hiring and training Lopez.

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27 *Id.* at 827, *citing Republic Nat'l Life Ins. Co. v. Heyward*, 536 S.W.2d 549, 555 (Tex. 1976) (emphasis added by *Cowan* court).

28 *Id.* at 828.

29 *Lindsey*, 997 S.W.2d at 154-155.

30 *Lindsey* at 155, *citing Heyward* at 557.

31 *Id.*

Dallas Fire refused to defend King, stating there was no "occurrence" because the actions of Lopez were intentional. King contended he was covered because he did not intend to injure Jankowiak and his only potential contribution to Jankowiak's injury was perhaps negligently hiring, training, or supervising Lopez, and therefore, from his standpoint, Jankowiak's injuries were the result of an occurrence.[32] The court ruled that the policy language (identical to the language in the 1998 and 2001 ISO forms) and the history behind the commercial general liability policy supported the conclusion that in determining whether or not there has been an "occurrence," it is the insured's standpoint that controls.[33] According to the court, the "better approach" is that the actor's intent is not imputed to the insured in determining whether there was an occurrence.[34]

In reaching its decision, the court relied upon the separation of insured's provision, which it described as creating separate insurance policies as to King and Lopez, and upon the "expected or intended injury" exclusion, which it determined would have no purpose if all intended injuries were excluded at the outset because they would not be an "occurrence."[35] Its duty, it said, is to give effect to all contract provisions and render none meaningless.[36]

The court asked "whether an employer's alleged negligent hiring, training, and supervision constitute an 'occurrence' under the terms of the insurance policy although the injury was directly caused by the employee's intentional conduct."[37] It noted that the claims against King for negligent hiring, training, and supervision were made in addition to a claim for *respondeat superior* liability for Lopez's conduct.[38] Arguably, its holding does not extend to a situation in which the insured principal, especially a corporate principal which can only act through its natural person employees and agents, is vicariously liable for the actor's intentional conduct. However, the court itself never made that distinction.

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32 *Id.* at 187-188.

33 *Id.* at 188.

34 *Id.* at 191-192.

35 *Id.* at 188-189.

36 *Id.* at 193. *But cf. State Farm Fire & Cas. Co. v. Volding*, 426 S.W.2d 907, 909 (Tex. Civ. App. – Dallas 1968, writ ref'd n.r.e.) ("an exclusionary clause . . . can never be said to create coverage where none existed before."). But courts also seem to be using the same reasoning in favor of insurance companies in interpreting coverage and additional insured provisions. *See Evanston v. Atofina Petrochemicals, Inc.*, 2006 WL 1195300, 49 Tex. Sup. Ct. J. 589 (May 5, 2006) (*rehearing granted*) (when two separate additional insured provisions apply, court will not ignore the limitations in the more applicable provision even though they are not present in the other); *Royal Ins. Co. v. Harford Underwriters Ins. Co.*, 391 F.3d 639, 642-643 (5th Cir. 2004) (Texas law) (where policy had professional liability forms and CGL form and "gravamen" of complaint is negligent medical case, only professional liability form applies in order to give the most meaning to the policy).

37 *Id.* at 186.

38 *Id.*

Obviously, the logic of *King* would allow an insured to argue that even though some or all of the defective work performed by its subcontractor may not constitute an "occurrence" from the subcontractor's standpoint, the damages are still caused by an "occurrence" from the insured's standpoint. For example, this is clearly a part of the court of appeals' reasoning in *Archon Investments*.[39]

The final, recent Texas Supreme Court case in play in the interpretation of "occurrence" is *Jim Walters Homes v. Reed*, 711 S.W.2d 617, 618 (Tex. 1986), which was an actual construction-defect suit. The jury found that Jim Walters Homes had breached its warranty of good workmanship and had been grossly negligent in supervising construction of the house. It award the plaintiff homebuyers both actual and exemplary damages. The supreme court's issue, however, was whether the gross negligence found by the jury was an independent tort that would support the award of exemplary damages.[40] The court held that the plaintiffs' injuries sounded only in contract in that the house they were promised and paid for was not the house they received. Therefore, they could receive only the benefit of the bargain damages, and punitive damages were not recoverable.[41]

Insurance companies have been arguing that the *Jim Walters Homes* language should be applied to consideration of an "occurrence" so that claims of poor workmanship or breach of warranty are not covered as they are merely breaches of contract.[42] The policyholders, however, and many courts, argue that the reasoning applicable to *Jim Walters Homes* does not apply to interpretation of a written insurance contract and claims concerning a duty to defend.[43]

2. The courts apply these cases to construction-defect coverage cases and cannot agree.

Using the Texas Supreme Court cases discussed above and other, related cases, the United States Fifth Circuit Court of Appeals and the various Texas courts of appeals have attempted to interpret the CGL policy as applied to constructive-defect cases. The results have been confused and contradictory. In the one case that the Texas Supreme Court has affirmatively decided to review upon certified questions, *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*,[44] the Fifth Circuit simply noted the confusing and contradictory lines of cases and arguments and decided the Texas Supreme Court would be better situated to make a definitive ruling.

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[39] 174 S.W.3d 334, 342 and n.8. 2005. *But cf. Grimes Constr.*, 188 S.W.3d at 814-816.

[40] *Id.* at 617-618.

[41] *See Southwestern Bell Tel. Co. v. DeLanney*, 809 S.W.2d 493-495 (Tex. 1991) (holding claimant could not recover in tort when only damage resulting from defendant's breach of contract was to the subject of the contract).

[42] *See, e.g., Lennar Corp.*, 200 S.W.3d at 666.

[43] *Id.*

[44] 428 F.3d 193 (5th Cir. 2005) (certified question accepted Nov. 4, 2005 – Texas Supreme Court Docket No. 05-0832).

The Dallas court of appeals and the Houston courts of appeals have adopted the policyholder positions on the interpretation of "occurrence" and related issues.[45] The Fort Worth court of appeals, however, seems to have adopted the insurance company position that the gravamen of the of the plaintiff's complaint should determine whether the case is purely an economic injury type-case that is not a "accident" such as to be an "occurrence."[46] Moreover, a number of the cases also discuss other issues, such as whether there is "property damage" and the applicability of various CGL exclusions. These cases are discussed in more detail in the accompanying paper, *Construction Defect Update: What's Building Up in Texas?*.

For purposes of this paper, I am providing a brief description of each case's ruling on the definition of "occurrence." An adjuster should be aware that these cases with wildly divergent rulings exist, that clarifying rulings are expected from the Texas Supreme Court, and that unless the adjuster decides to accept coverage without reservation, reservations of rights should be issued based on the appropriate cases concerning "occurrence" (as well as the other issues, such as the definition of "property damage" discussed in this paper).

The *Lamar Homes* case is the one of the previously-listed six cases that the Texas Supreme Court has actually accepted for decision. The court heard oral arguments on February 14, 2006, almost a year ago, but has not yet issued an opinion. The fact that the court has requested full briefing on the merits on three of the related-issue cases (*Gehan Homes*, *Archon Investments* and *Grimes Construction*) is indicative that the court is interested in these issues.[47]

In *Lamar Homes*, the Fifth Circuit asked the Texas Supreme Court to answer the "occurrence" question succinctly:

> When a homebuyer sues his general contractor for construction defects and alleges only damage to or loss of use of the home itself, do such allegations allege an "accident" or "occurrence" sufficient to trigger the duty to defend or indemnify under a CGL policy?[48]

In the underlying case, the home purchasers, the DiMares, alleged that Lamar Homes and its subcontractor were negligent and failed to design and/or construct the foundation of the home in a good and workmanlike fashion in accordance with implied and expressed warranties. The

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[45] *Gehan Homes*, 146 S.W.3d 833; *Archon Inv.*, 174 S.W.3d 334; *Lennar Corp.*, 200 S.W.3d 651; and *Pine Oak Builders*, ___ S.W. ___, 2006 WL 1892669.

[46] *Grimes Constr.*, 188 S.W.3d 805.

[47] Under Texas appellate procedure, someone appealing to the Texas Supreme Court from a court of appeals first files a limited brief requesting that review be granted. The Texas Supreme Court may request full briefing on the merits before deciding whether to accept the case. Although such a request does not mean the court will accept the petition for review, it is indicative of some interest in the issues by at least some of the Justices. In this situation, the court could simply be seeking further briefing on the issues already before it in *Lamar Homes* as applied in different situations.

[48] 28 F.3d at 200. The court additionally asks the Texas Supreme Court whether loss of use of the home alleges "property damage" as discussed subsequently.

insurer, Mid-Continent Casualty, refused to defend, and Lamar filed suit against Mid-Continent seeking a declaration that the policy covered the claims alleged.

On cross motions for summary judgment, the district court reasoned that because the gravamen of the underlying petition sought relief for a breach of contract and pure economic loss, there was no duty to defend because such a result would transform a liability policy into a performance bond.

On appeal, the Fifth Circuit noted the widely divergent results in cases in Texas on the issue.[49] The Fifth Circuit did not even attempt to harmonize or pick between the numerous cases. Instead, it simply noted:

> Given the frequency this issue is litigated and the copious amount of conflicting case law on both sides regarding whether construction errors causing damage to the subject of the contract constitute an "occurrence" causing "property damage" under a CGL policies, we believe that this is an issue that the Texas Supreme Court should consider resolving.[50]

The *Gehan Homes* case was decided firmly in favor of the policyholder, but it provided little in depth analysis of the conflicting cases and relied heavily on the liberal standards for coverage to be invoked in a duty to defend the case. In the underlying petition of the homeowners, they specifically alleged negligence in addition to breach of contract, breach of warranty, and related claims.[51] Again, the insurer denied coverage and Gehan Homes sued the insurer. On cross motions for summary judgment, the trial court ruled in favor of the carrier. The *Gehan Homes* court noted the different lines of cases on the issue and discussed the Texas Supreme Court cases mentioned above. The court did not appear, however, to make any attempt to harmonize the various cases or arguments. Instead, it simply determined that because a duty to defend is based exclusively on the pleadings and the language of the policy, and the Larsons suit made claims of negligence, there was a duty to defend.

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[49] *See* Texas intermediate courts of appeals and federal district court cases cited at 428 F.3d 197 n.6 and n.7.

[50] *Id.* at 199. The court also noted the Texas Supreme Court had already requested briefs on the merits in the *Gehan Homes* case.

[51] The court also found that the underlying claimants sufficiently alleged a claim of bodily injury creating coverage under the policy because under a heading entitled "Mental Anguish," they made the statement that they "suffered a great physical and mental pain." Although the insurers argued that this was insufficient to allege "bodily injury" because the insurance policies do not include injuries that are solely mental in nature, citing *Trinity Universal Ins. Co. v. Cowan*, 945 S.W.2d 819, 823 (Tex. 1997), the court of appeals liberally construed the allegations in favor of Gehan Homes to establish bodily injury coverage. This additional ground for coverage may either provide an avenue for the Texas Supreme Court to further explain what is necessary as a complaint-allegation to invoke coverage or provide a mechanism by which the court need not reach the "occurrence" and "property damage" issues in that particular case.

The Houston courts of appeals provided more extensive analysis in their cases, *Archon Investments*, *Lennar Corp.*, and *Pine Oak Builders*.[52] *Archon Investments* was another duty-to-defend case. The homeowner in the underlying claim alleged that there was leakage and resulting damage because the stucco siding or windows had been improperly installed. He sued Archon Investments and two of its subcontractors for claims including breach of contract, breach of warranty, and negligence. The court of appeals ruled that there were allegations of an "occurrence," relying heavily on the duty-to-defend analysis. It noted the specific allegations that the work was done by subcontractors and stated that Archon could not have intended that negligent work of its subcontractors cause damage to the property. It also analyzed the carrier's argument that *Jim Walters Homes* meant there was no "occurrence" because the only injury was to the economic subject of the itself. The court distinguished *Jim Walters Homes* as being a case decided on the actual facts between the homeowner and the builder as opposed to a duty-to-defend case based on the pleadings of a case that has not been decided. It declined to extend *Jims Walters Homes* to the duty-to-defend area. Therefore, it found that within the eight-corners of the underlying complaint and the policy there was a duty to defend.

The court explicitly declined to decide whether there was a duty to indemnify, however, because the underlying suit had not been determined and there were no jury findings as to the various causes of action. It distinguished the insurer's reliance on the court's earlier *Hartrick v. Great American* case.[53] It ruled the *Hartrick* case was a duty-to-indemnify case in which the underlying jury had actually found breaches of warranty, but no negligence. Therefore, the jury's responses found that the builder "voluntarily and intentionally" failed to comply with its implied promises and its conduct was not accidental.[54] Because those determinations cannot have been made on the pleadings alone, they did not apply to the duty-to-defend in *Archon Investments*.

The other Texas court of appeals for Houston, the Fourteenth District, likewise found for the policyholder in the *Lennar Corp.* case. There, the builder, Lennar Corp., received numerous complaints regarding problems with its exterior insulation and finish systems ("EIFS"). It was involved in several suits and prophylactically removed EIFS from numerous homes and replaced it with tradition stucco. It also repaired resulting water damage to the homes.

Lennar sought indemnification for its actual replacement and repair costs from a number of carriers, and they refused. The court of appeals decided the issues on appeal based upon the insurers' successful motions for summary judgment and started by also noting the unsettled nature of Texas law on whether defective construction can constitute an occurrence.[55] The court

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[52] Because *Pine Oak Builders* was decided by the same court as *Lennar Corp.* within the same year, it basically adopts the same reasoning on an "occurrence" as *Lennar Corp*. It does contain more extensive discussion concerning other aspects of the CGL policy as applied to construction-defect cases.

[53] *Hartrick v. Great American Lloyd's Ins. Co.*, 62 S.W.3d 270 (Tex. App. – Houston [1st Dist.] 2001, no pet.).

[54] *Archon Investments*, 174 S.W.3d at 343, *discussing Hartrick*, 62 S.W.3d at 277-278.

[55] 200 S.W.3d at 664-668.

ruled, however, that such risks are ordinarily eliminated through exclusions, not the general insuring provisions. It also limited the Texas Supreme Court's decision in *Jim Walters Homes* to issues of recovery in an underlying lawsuit, not determinations of insurance coverage.[56]

The court then determined the issue by an analysis of (1) the "business risk" exclusions, (2) their history, and (3) the effect a ruling that construction defects are not an occurrence would have on the meaningfulness of the exclusions. In fact, it noted that in most or all of the cases cited by the insurance carriers, the court did not consider the effects of those exclusions on the "occurrence" analysis.[57]

The court found that defining "occurrence" in such a way as to eliminate construction-defect cases would make most of the "business risk" exclusions redundant. It noted the history of the "your work" exclusion and that it now includes an exception for when the damaged work, or the work at which a damage arose, was performed by subcontractors. The court ruled that the addition of this exception and its history showed that insurance companies intended "occurrence" to potentially include construction defects. Therefore, it ruled that there generally was a duty to indemnify for construction defects under the definition of "occurrence," but that the "business risk" exclusions might remove that coverage in appropriate cases.

Just when it appeared that the Texas courts of appeals were uniformly ruling against the carriers' "occurrence" argument, the Fort Worth Court of Appeals ruled in their favor in the *Grimes Construction* case.[58] This is especially surprising, as numerous factors would indicate that the *Grimes Construction* case was very likely to be a policyholder victory. First, the case included claims for recovery under a duty to defend, not just a duty to indemnify. Second, the allegations included express allegations of negligence and negligent hiring and supervision. In fact, the court of appeals noted that the underlying petition contained "more than just conclusory allegations of negligence."[59] Finally, subcontractors were involved in the allegations concerning the construction of the home.

The Fort Worth Court of Appeals, however, adopted fully the carrier's argument that CGL policies are just not meant to cover what are essentially breach of contract and breach of warranty claims where the damages are the subject of the contract. It found that an underlying claimant merely recharacterizing an act as negligence does not overcome the basic facts underlying the claim and compel coverage.

Grimes Construction also did not find a negligent hiring claim required coverage. Although it noted the Texas Supreme Court ruling in *King v. Dallas Fire Ins. Co.*[60] that negligent

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56 *Id.* at 669.

57 *Id.* at 670.

58 188 S.W.3d 805.

59 *Id.* at 812.

60 85 S.W.3d 185 (Tex. 2002).

hiring, training, and supervision can be an occurrence under a CGL policy, it distinguished *King* because there the employee's actions were intentional and outside of the course and scope of employment. The *Grimes Construction* court found that a subcontractor's actions in furtherance of its contractual duties are more foreseeable than torts outside of the course and scope of employment. The *Grimes Construction* underlying petition did not allege the commission of an intentional tort or crime, but simple negligence, which the court found to be a reasonably foreseeable result of the alleged conduct. Therefore, there was not an "occurrence" under the policy such as to create a duty-to-defend or a duty-to-indemnify.

3. So where are you as an adjuster on the existence of an "occurrence?"

As an adjuster, you must be aware of the split of authority. You should be aware of the cases pending before the Texas Supreme Court, and determine whether these issues have been decided, in whole or part, before issuing your coverage determination or reservation of rights. In many cases, there will be other reasons discussed in this paper for you to deny or reserve rights, but in determining whether to do so based on occurrence, you should keep in mind several questions:

1) Is the claim by the insured for a duty to defend or a duty to indemnify?

2) Is there a claim of duty to indemnify based on an underlying complaint only or there are findings in the underlying case of negligence or similar non-intentional conduct?

3) Do the underlying claims or allegations involve negligence of subcontractors or simply those of the builder or contractor?

4) Are any allegations of negligence merely attempts to recast a breach of warranty and breach of contract claims as negligence, or do they seem to have an actual independent basis?[61]

B. Was the "occurrence" during the policy period?

Assuming that the insured's defective construction has resulted in "property damage" caused by an "occurrence," which policy will cover it or must defend a claim concerning it? The policy in effect at the time the insured did the work? The policy in effect at the time the damage from the defective work was discovered? Or, the policy or policies in effect at some other time between when the work was performed and when the suit was filed or the claim made?

[61] Of course you may have additional arguments such as failure to provide notice or that there was a voluntary payment if the carrier was not involved in the underlying case or claims.

1. Which trigger of coverage applies: the exposure trigger or the manifestation trigger?[62]

The language of the ISO policy forms and of most other general liability forms and policies require the "property damage" to occur "during the policy period." The question of when the "property damage" occurs has not been often litigated in Texas, but is now at issue in the *Pine Oak Builders* case.[63] In *Pine Oak Builders*, the insurers argued that Texas had adopted a "manifestation" trigger under which the applicable policy is the one in effect when the complaining party was actually damaged and that a party sustains actual damage when the damage becomes "readily apparent" or "manifest."[64] The insured argued, however (and ultimately the court agreed), that an "exposure" trigger applied, under which the insured is covered for all "claims based on an event occurring during the policy period, regardless of whether the claim or occurrence is brought to the attention of the insureds or made know to the insurer during the policy period."[65]

The court noted that the Texas Supreme Court has refused to adopt or reject the manifestation rule[66] and that only two courts of appeals have adopted it as well as the Fifth Circuit as an interpretation of Texas law.[67] It further noted that none of these cases appeared to involve policies that defined "occurrence" so as to include "continuous or repeated exposure to condition" such as the CGL policy before it and before the other Houston court of appeals in the *Pilgrim Enterprises* case.[68] Accordingly, it decided to follow the *Pilgrim Enterprises* court's reasoning in adopting the "exposure rule."[69]

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[62] Some cases may not require a detailed determination of the proper trigger. The *Gehan Homes* court found a duty to defend when the claimant's petition simply alleged "past" bodily injuries and property damages without an identification of when they specifically occurred. 146 S.W.3d at 845-846. In such a case, however, an insurer can try to argue that the claimant's pleading does not establish coverage on its face such as to create a duty to defend. *Cf. Pine Oak Builders* at *5 (court refuses to assume subcontractors were involved, which would have invoked an exception to a policy exclusion, but note that the ruling was in the context of a pleading that alleged only facts that excluded coverage unless an assumption was made that a subcontractor was involved).

[63] *Pine Oak Builders, Inc. v. Great American Lloyds Ins. Co.*, ___ S.W.3d, 2006 ___ WL 1892669, Case No. 14-05-00487-CV (Tex. App. – Houston [14th Dist.] July 6, 2006, pet. requested Oct. 4, 2006).

[64] *Id.* at *6-*8.

[65] *Id* at *7, *quoting Pilgrim Enterprises, Inc. v. Maryland Cas. Co.*, 24 S.W.3d 488, 496 (Tex. App. – Houston [1st Dist.] 2000, no pet.), *in turn quoting Yancey v. Floyd West & Co.*, 755 S.W.2d 914, 918 (Tex. App. – Fort Worth 1988, writ denied).

[66] *See American Physicians Ins. Exch. v. Garcia*, 876 S.W.2d 842, 853 n.20 (Tex. 1994).

[67] *Citing State Farm Mut. Auto. Ins. Co. v. Kelly*, 945 S.W.2d 905, 910 (Tex. App. – Austin 1997, writ denied); *Cullen/Frost Bank v. Commonwealth Lloyds Ins. Co.*, 852 S.W.2d 252, 257 (Tex. App. – Dallas 1993, writ denied); *Dorchester Dev. Corp. v. Safeco Ins. Co.*, 737 S.W.2d 380 (Tex. App. – Dallas 1987, no writ); *American Home Assurance Co. v. Unitram, Ltd.*, 146 F.3d 311, 313 (5th Cir. 1998).

[68] *Pilgrim Enterprises, Inc. v. Maryland Cas. Co.*, 24 S.W.3d 488, 496 (Tex. App. – Houston [1st Dist.] 2000, no pet.).

[69] *Id.* at *7, quoting *Pilgrim*, 24 S.W.3d at 497.

Based on these lines of cases, there is a split of authority whether the "exposure" trigger or the "manifestation" trigger applies. Unless and until the Texas Supreme Court should decide the issue (perhaps even for the *Pine Oak Builders* case), an adjuster should be prepared to reserve rights on this issue (if appropriate). If a coverage suit is filed by the insurer, an attempt should be made to file it where it will be reviewed by a court adopting the trigger rule most useful to the carrier. If one is filed by the insured, the carrier should determine the current position of the appellate court that reviews that trial court's decisions.

2. Does the "known loss" or "loss in progress" doctrine bar coverage anyway?

Another timing issue that can affect coverage is fortuity, which is an inherit requirement of all risk insurance policies.[70] Both the "known loss" and the "loss in progress" doctrines are parts of the fortuity doctrine.[71] A "known loss" is a loss the insured knew had occurred at the time it purchased the policy.[72] A "loss in progress" occurs when the insured is, or should be, aware of an ongoing progressive loss at the time it purchased the policy[73] Insurance coverage is precluded for a "known loss" or "loss in progress."[74]

These concepts in the context of a construction-defect coverage case have been expressly discussed in *Lennar Corp.*[75] From early 1996 through late 1999, Lennar built more than 400 homes in the Houston area using EIFS, which it contended was marketed as an ideal product for wood-framed homes. Lennar later discovered that EIFS was defectively designed such that it trapped water behind it and did not allow the water to drain. By September 1999, however, it was convinced that EIFS was a defective product. Thereafter, it removed the EIFS from all the homes and replaced it with traditional stucco. Lennar's insurers claimed that Lennar was barred from coverage by the "known loss" and "loss in progress" doctrines based on Lennar's knowledge of EIFS-related damages of a few homes as of June 1, 1999, and testimony of an employee that beginning in 1995, Lennar had repaired EIFS-related problems on several homes.

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[70] *Lennar Corp.*, 200 S.W.3d at 687; *Scottsdale Ins. Co. v. Travis*, 68 S.W.3d 72, 75 (Tex. App. – Dallas 2001, pet. denied); *see Two Pesos, Inc. v. Gulf Ins. Co.*, 901 S.W.2d 495, 501 (Tex. App. – Houston [14th Dist.] 1995, no writ).

[71] *Id.*

[72] *Lennar Corp.*, 200 S.W.3d at 687; *Travis*, 68 S.W.3d at 75, *citing Burch v. Commonwealth County Mut. Ins. Co.*, 450 S.W.2d 838, 840-841 (Tex. 1970).

[73] *Lennar Corp.*, 200 S.W.3d at 688; *Travis*, 68 S.W.3d at 75; *Two Pesos*, 901 S.W.2d at 501.

[74] *Id.*

[75] *Lennar Corp. v. Great American Ins. Co.*, 200 S.W.3d 651, 687-690, 693-695 (Tex. App. – Houston [14th Dist.] 2006, pet. for review filed May 11, 2006).

The court first ruled that for the homes that Lennar actually knew had problems at the time it purchased the varying policies, coverage was barred.[76] With respect to the remaining homes, however, there was a fact issue (which precluded summary judgment) about what Lennar knew and when. On the insurers' side, the evidence showed that as far back as 1995, Lennar had begun repairing EIFS-related damage to a few homes.[77] In 1997, it was named as a defendant in a lawsuit alleging EIFS as a defective product. During the spring of 1999, Lennar expressed an increase in homeowner "inquiries" following television programs regarding EIFS. Furthermore, during that period, several Lennar employees, including more senior personnel "discussed" EIFS issues and several employees spent a total of 266 hours on EIFS issues. In May 1999, several employees were approved to attend an EIFS remediation seminar to take place in June 1999. The court noted this evidence strongly suggested that Lennar should have realized the magnitude of the problem by June 1, 1999.[78]

Lennar presented some contradictory evidence, however.[79] Its testimony was that through the spring of 1999 it had received a few complaints, but it did not suspect an inherit defect in EIFS. Instead, the EIFS manufacturers assured Lennar that any problems were due to installation error. It was not until September 1999, after Lennar spent the summer responding to more complaints, that it recognized a systemic product defect that would likely involve hundreds of homes. It was at that time that it modified its plan to address the problems, decided to identify all EIFS homes and determine the number of staff members necessary to address the claims, and discussed whether to notify Lennar's CGL insurers of the claims. The court found that these facts, under standards applicable for a summary judgment proceeding, were sufficient to raise a question of fact that must be resolved by the trial court.

Lennar Corp. is currently the prime Texas authority on fortuity as applied to construction-defect claims. If you have similar issues involving a policy, you should conduct a broad inquiry into what the defendant builder knew and when they knew it. For more recent policies, however, you should note that the changes in the insuring agreement in the ISO 2001 policy form may limit the application of the fortuity doctrine or known loss rule. It was specifically amended to include language that coverage only applies if no insured listed in paragraph 1 of the "Who Is An Insured" section or an employee authorized by the named insured to give or receive notice of an "occurrence" or claim knew that the damage had occurred, in whole or in part, prior to the policy period. These provisions speak only in terms of actual knowledge on the part of certain persons, not the "knew or should have known" common law standard. An insured could argue that this sets a higher standard. But the carrier can argue that this language changes only the interpretation of "occurrence" and does not alter the fortuity requirement as that is an inherent policy requirement. No Texas court has ruled on the effect of the 2001 insuring agreement language on the common law doctrine.

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[76] *Id.* at 688-689, 693-694.

[77] *Id.* at 688-689.

[78] *Id.* at 689.

[79] *Id.* at 689.

C. Were the claimed damages sums that the insured was "legally obligated to pay because of 'property damage'"?

Some of the same recent cases that have discussed whether a construction-defect is an occurrence, also discussed when and to what extent resulting damages are "property damage" that the insured is legally obligated to pay. Again, the one case that has actually been accepted by the Texas Supreme Court, *Lamar Homes*,[80] simply notes a split of authority and transfers the issue to the Texas Supreme Court without attempting to harmonize the cases.[81] It also noted the *Lennar Corp.* court's argument that the changes to the "your work" exclusion to except subcontractors from the exclusion shows that property damage should include construction-defect cases,[82] but that the carriers responded that the argument was merely an attempt to use exclusions to create coverage, which was inappropriate.[83] *Lamar Homes* certified the question to the Texas Supreme Court of:

> When a homebuyer sues his general contractor for construction defects and alleges only damage to or loss of use of the home itself, do such allegations allege "property damage" sufficient to trigger the duty to the defend or indemnify under a CGL policy?[84]

The certified question was accepted, and oral argument before the Texas Supreme Court was held on February 14, 2006. No opinion has yet been issued.

The *Gehan Homes* court[85] simply stated the same analysis that required it to find an occurrence meant it could not disregard the claims. The underlying claimants alleged a "loss of use" of claim by seeking damages for a reasonable expense of temporary housing. They also made an allegation that they suffered physical injury to tangible property. The *Gehan Homes* court, following its strict interpretation of the "eight corners" rule, ruled such is sufficient to require a defense of the underlying claim.

The *Lennar Corp.* court provided a more detailed analysis of what type of damages are actually covered and when, probably because it was an actual suit for indemnity, rather than a

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80 428 F.3d at 193.

81 *Id.* at 198.

82 *Id.* at 198-199.

83 *Id.* at 199, noting the insurer's cited case of *State Farm Fire & Cas. Co. v. Volding*, 426 S.W.2d 907, 909 (Tex. Civ. App. – Dallas 1968), writ ref'd n.r.e.) ("an exclusionary clause . . . can never be said to create coverage where none existed before.").

84 *Id.* at 200.

85 *Gehan Homes, Ltd. v. Employers Mut. Cas. Co.*, 146 S.W.3d 833 (Tex. App. – Dallas 2004, pet. filed Jan. 5, 2005, briefing on the merits requested June 6, 2005) (discussed in connection with the "occurrence" definition *supra.*).

defense.[86] Lennar had been involved in several suits for claims where it had replaced EIFS damages, but then on its own had replaced EIFS with actual stucco in hundreds of home as it became aware of the scope of the issue. The policy defined "property damage" as "[p]hysical injury to tangible property, including all resulting loss of use of that property."[87] Lennar claimed that all its costs were recoverable damages. The *Lennar Corp.* court disagreed and divided Lennar's damages into three categories: (a) the cost to repair water damage to the homes, which it found was recoverable; (b) the cost to remove and replace EIFS as a preventative measure, which it found was not covered; and (c) overhead costs, inspection costs, personnel costs, and attorney's fees, which it found were not property damage.

According to the summary judgment evidence, the EIFS' entrapment of moisture caused water damage to at least some of the homes. That damage could include wood rot, damage to the substrate, sheathing, framing, insulation, sheetrock, wallpaper, paint, carpet, carpet padding, wooden trim and baseboards, mold damage, and termite infestation. The court found these to constitute "physical injury to tangible property."[88] The court also found costs for work such as replacing broken windows, repairing cracked driveways, and replacing landscaping that was damaged to repair the water damage was recoverable.[89] The cost to remove EIFS solely to repair underlying water damages were also recoverable damages.[90] The court noted that there was conflicting evidence on whether all of the homes sustained water damages. Therefore, it could not determine whether there were recoverable damages for all the homes, but did hold that the cost to repair homes that did sustain water damage was recoverable.[91]

The parties disagreed about coverage for the general replacement of the EIFS. The carriers asserted that replacement of an initially defect product is not "property damage"[92] relying on a line of cases holding that when the product was never in an initial satisfactory state that was changed by an external event to an unsatisfactory state, it came into an existence in a damaged state and its condition was not "physical damage."[93] The court agreed, stating that the

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86 *Lennar Corp.*, 200 S.W.3d at 677-681.

87 *Id.* at 677. The court noted that "property damage" was also defined as "[l]oss of use of tangible property that is not physically injured," but apparently none of the homeowners claims "loss of use" due to EIFS.

88 *Id.* at 677, *citing American Family Mut. Ins. Co. v. American Girl, Inc.*, 268 Wis.2d 16, 673 N.W.2d, 65, 74-75 (2004).

89 *Id.* at 678 n.33.

90 *Id.*

91 *Id.*

92 *Id.* at 678.

93 *Id., relying on North American Shipbuilding, Inc. v. Southern Marine & Aviation Underwriting, Inc.*, 930 S.W.2d 829, 832-834 (Tex. App. – Houston [1st Dist.] 1996, no writ); *Fidelity & Deposit Co. of Maryland v. Hartford Cas. Ins. Co.*, 215 F.Supp.2d 1171, 1183 (D.Kan. 2002).

EIFS was not physically injured after application to the homes, changed from a satisfactory state into an unsatisfactory state, or otherwise physically altered.[94]

Finally, the court overruled Lennar's claim for overhead costs, inspection costs, personnel costs, and attorney's fees as "property damage" because the claim ignored the "legally obligated to pay" language in the insuring agreement.[95] The court noted that while Lennar may have been legally obligated to pay the third-party EIFS claims by replacing EIFS, making repairs, or making cash payments, it was not legally obligated to incur its own overhead costs, inspection costs, personnel costs, and attorney's fees in connection with settling the claims. The court further noted that the insuring agreement refers to the "claimant's" damages that the insured becomes legally obligated to pay, not Lennar's costs. Interestingly, the court of appeals was not required to make determinations of whether those type costs were recoverable under a duty-to-defend doctrine or whether the EIFS claims in the entirety were not claims that Lennar was not "legally entitled to pay" because there was no judgment.[96] Apparently, in the original summary-judgment motion, several carriers had argued that Lennar was not "legally obligated to pay" the EIFS claims because it settled them without suit being filed.[97] Lennar alleged that the Residential Construction Liability Act ("RCLA") legally obligated Lennar to cure construction defects without suit being filed. But the carriers did not pursue their argument on appeal, so it was not decided.

In summary, determination of whether there is property damage recoverable under the policy or requiring a duty to defend will depend on the underlying facts. In a "duty to defend" context, a simple allegation of harm to the building or loss of use will be sufficient to require a duty to defend, unless you are before a court that has adopted the general theory that "business risks" are not covered under the definition of an "occurrence" or "property damage," or unless the Texas Supreme Court addresses the issue adversely to policyholders.

Even in the most policyholder-favored case, however, *Lennar Corp.*, only actual damage to the property (or potential loss of use) is covered, not the cost to replace defective construction products in general or the costs of the policyholder in doing so.

III. EVEN IF THERE IS BASIC COVERAGE, DO EXCLUSIONS ELIMINATE IT?

Even when the insuring agreement provides general coverage, CGL policies have exclusions that would apply to most construction-defect claims because CGL policies are not meant to cover most business risks. Common exclusion issues can be examined by looking at some common ISO CGL exclusions, but again, a prudent adjuster must examine the particular

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94 *Id.* at 678.

95 *Id.* at 680.

96 Likewise, the issue of whether Lennar had acted as a "volunteer" in replacing all of the EIFS was not before the court of appeals.

97 *Id.* at 680 n.37.

language in his policy, not that is used commonly. Moreover, many of the exclusions have further exceptions for limited purposed, most of which are beyond discussion in this paper.

For convenience, I will order the exclusion discussion as they appear in a typical CGL policy.

A. Do some of the exclusions apply only to the named insured?

Before discussing the exclusions, you should note that several them use the term "you" and "your." The usual policy provides that the terms "you" and "your" refer to the named insured shown in the declaration and any other person or organization qualifying as a named insured. When there is an additional insured on the policy, or a mere "insured" that is not also a named insured, an insured may argue the applicability of some of the exclusions limited, including (j)(1), (j)(2), (j)(5), (j)(6), (l) and (m). Exclusions (j)(6) and (l) use the defined term "your work" rather than the stand-alone word "you" or "your," but the definition of "your work" is "work or operations performed by you [the named insured] or on your [the named insured's] behalf." There is no reported Texas case in which a court has considered the applicability of any of these exclusions to an insured who is not a named insured, such as an additional insured. However, the Houston First Court of Appeals has considered and rejected an additional insured's argument that because the language in a policy's deductible endorsement used the words "you" and "your," the deductible provision would not apply to the additional insured.[98] The court reasoned that construing the deductible provision so that it did not apply to the additional insured would render the provision meaningless with regard to the additional insured while simultaneously leaving it valid and enforceable with respect to the named insured.[99]

B. Exclusion (a) – Expected or Intended Injury

This provision usually excludes:

> "Bodily injury" or "property damage" expected or intended from the standpoint of the insured. This exclusion does not apply to "bodily injury" resulting from the use of reasonable force to protect persons or property.[100]

The focus is on the effect of the insurer's act – the injury or damage – and not on the act itself.[101] Given the analysis of the similar issue with respect to "occurrence" discussed previously, it is difficult to see how this provision concerns any issue not already addressed by the definition of "occurrence," an interpretation that is in direct contradiction of the Texas

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98 *Phillips Petroleum Co. v. St. Paul Fire & Marine Ins. Co.*, 113 S.W.3d 37, 44 (Tex. App. – Houston [1st Dist.] 2003, pet. denied).

99 *Id.*

100 *See, e.g.*, ISO Form CG 00 01 12 04 (2003).

101 *Gulf Chemical & Metallurgical Corp. v. Associated Metals & Minerals Corp.*, 1 F.3d 365, 370 (5th Cir. 1993).

Supreme Court's ruling in *King* that all portions of the policy must be given effect.[102] In any event, when it appears that conduct is arguably inclusive under this exclusion, an adjuster should reserve rights under this provision.[103]

C. Exclusion (b) – Contractual Liability

The pertinent portion of the exclusion precludes coverage for:

> "Bodily injury" or "property damage" for which the insured is obligated to pay damages by reason of the assumption of liability in a contract or agreement. 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", provided the "bodily injury" or "property damage" occurs subsequent to the execution of the contract or agreement. . . .[104]

In analyzing the business risk exclusions, some courts distinguish tort and contractual liability.[105] This exclusion is generally not considered a business risk exclusion, but practitioners frequently misunderstand the way in which it functions.[106] It does not apply to every breach of contract case, but only to cases involving contracts whereby the insured has indemnified a third party for damages.

The key phrase in the contractual liability exclusion is "assumption of liability," by which courts have distinguished contractual liability (*e.g.*, breach of contract) with an indemnification agreement.[107] In a construction-defect claim in which a general contractor is being sued for defective workmanship by the owner or project manager, the general contractor is being sued for

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[102] *King v. Dallas Fire Ins. Co.*, 85 S.W.3d 185 (Tex. 2002).

[103] As well as the definitions of "occurrence" and/or "property damage," depending on the outcome of the Texas Supreme Court review of the cases discussed herein.

[104] ISO Form CG 00 01 12 04 (2003).

[105] *See American Family Mut. Ins. Co. v. American Girl, Inc.*, 673 N.W.2d 65, 76 (Wis. 2004) ("We agree that CGL policies generally do not cover contract claims arising out of the insured's defective work or product, but this is by operation of the CGL's business risk exclusions . . ."); *Jacob v. Russo Builders*, 592 N.W.2d 271, 276-277 (Wis. Ct. App. 1999) (damages for repair and replacement to insured's masonry work were for "economic loss resulting from contractual liability" and hence excluded; but damages for physical damage to other parts of house "inflicted" by masonry work were for tort damages and hence, recoverable). *But cf. Lennar Corp.* 200 S.W.3d 651.

[106] *See Lennar Corp.*, 200 S.W.3d at 692-693.

[107] *Id. See American Family Mut. Ins. Co. v. American Girl, Inc.*, 673 N.W.2d 65, 80-81 (Wis. 2004); *Federate Mut. Ins. Co. v. Grapevine Excavation, Inc.*, 197 F.3d 720, 726-727 (5th Cir. 1999) ("[t]his exclusion operates to deny coverage when the insured assumes responsibility for the conduct of a third party.").

its own liability – not its assumption of the liability of a third party. Hence, the exclusion does not apply to such claims.[108] Further, while the general contractor may have contractually agreed to indemnify the owner, if the contractor would be liable on general principles of common law, the contractual liability exclusion does not bar coverage.[109]

Also important for construction-defect claims is the exception to the exclusion, which may be a source of coverage if the suit or claim alleges otherwise covered damages (*i.e.*, "bodily injury" or "property damage" caused by an "occurrence") that occurred subsequently to execution of the contract and provided that the contract meets one of the definitions of "insured contract." (Although a comprehensive discussion of "insured contract" coverage is outside the scope of this paper, I am noting the issue here for the sake of completeness.) CGL policies contain multiple definitions of "insured contract," but the most important definition in the construction-defect context is the following:

> f. That part of any other contract or agreement pertaining to your business (including an indemnification of a municipality in connection with work performed for a municipality) under which you assume the tort liability of another party to pay for "bodily injury" or "property damage" to a third person or organization. Tort liability means a liability that would be imposed by law in the absence of any contract or agreement.[110]

Thus, "insured contract" coverage is often available to the named insured for indemnity obligations owed under a construction contract even when the exclusion would otherwise apply.

D. Exclusion (f) – Pollution

Under a typical CGL policy, exclusion (f) removes coverage for "bodily injury" or "property damage" arising from pollution. An analysis of this exclusion in full, and its multiple variations,[111] is beyond the scope of this paper. The adjuster should be aware of it and its potential applicability to potential cases. Typical claims of damage that may or may not be excluded, depending on the particular pollution exclusion and the facts are claims from smoke or vapors due to a fire onsite or otherwise, claims of damage to property from chemical or similar waste runoff, and claims of ground contamination.

E. Exclusion (j) – Damage to Property

The main portions of this exclusion exclude recovery for:

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[108] *Grapevine*, 197 F.3d at 726-727. *See also Lennar Corp.*, 200 S.W.3d at 692-693.

[109] *Id.* at 727.

[110] There are applicable exceptions to this definition. *See* CG 00 01 12 04 (2003).

[111] For example, the so-called "sudden and accidental" pollution exclusion, the "absolute" pollution exclusion, and the "total" pollution exclusion, as well as numerous individually crafted endorsement exclusions.

"Property damage" to:

(1) Property you own, rent or occupy . . .;

(2) Property you sell [. . .], if the "property damage" arises out of any part of those premises;

* * *

(4) Personal property in the care, custody or control of the insured;

(5) That particular part of real property on which you or any contractors or subcontractors working directly or indirectly on your behalf are performing operations, if the "property damage" arises out of those operations; or

(6) That particular part of any property that must be restored, repaired or replaced because "your work" was incorrectly performed on it.

Paragraphs (1), (3), and (4) of this exclusion do not apply to "property damage" (other than damage by fire) to premises, including the contents of such premises, rented to you for a period of 7 or fewer consecutive days. . . .

Paragraph (2) of this exclusion does not apply if the premises are "your work" and were never occupied, rented or held for rental by you.

Paragraphs (3), (4), (5), and (6) of this exclusion do not apply to liability assumed under a side-track agreement.

Paragraph (6) of this exclusion does not apply to "property damage" included in the "products-completed operations hazard."[112]

Sub-exclusions (1), (2), and (4) apply to property directly "owned" by the insured, while sub-exclusions (5) and (6) address damage during a certain time-frame – while the construction project is ongoing. You should note that exclusion (j) works in combination with exclusion "(l) – Damage to Your Work."[113] Exclusion (j) is concerned with damage while the project is ongoing, but exclusion (l) deals with damage to work that is not discovered until after completion of the project.

[112] ISO Form CG 00 01 12 04 (2003).

[113] Discussed below.

1. Exclusions (j)(1), (2), and (4) – Owned Property, Sold Property, Care, Custody, and Control

Exclusion (j)(1) excludes coverage for damage to property that the named insured owns, rents, or occupies. Exclusion (j)(2) excludes coverage for damage to property that the named insured sells, if the property damage arises out of any part of those premises, and (j)(4) excludes coverage for personal property in the insured's care, custody, or control.

Surprisingly, the applicability of these exclusions to construction-defect cases is not often litigated in Texas. The potential applicability of these exclusions could become more important in long-term, progressive damages cases if the trigger of coverage is determined to be an "exposure" or similar trigger[114] so that property damage will have occurred even before the work was completed and before the claimant bought the property. Certainly, in the case of an insured that actually owned the property and improvements before selling it to the claimant, coverage for damage that occurred during the time the builder or developer owned it should be excluded by (j)(1) and any damage that occurred after the builder/developer sold it should be excluded by exclusion (j)(2).[115]

For a general contractor of a building, there is authority that coverage may be excluded for property damage that occurred while the general contractor was still constructing the building and before he turned it over to the owner – that is, while he "occupied" the property.[116] But if an insured subcontractor or contractor who contracts to perform only partial work or remodeling work on an existing building, it will be more difficult to prove that the insured "occupied" the property. In *Hartford Cas. Co. v. Cruse*,[117] the Fifth Circuit considered an exclusion for damage to property in the insured's care, custody, or control or over which the insured was for any purpose exercising control.[118] The *Cruse* court rejected the insurer's argument that the parts of the house other than the foundation were in the care, custody, or control of the insured

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114 *See* §II.B.1, *supra.*

115 *See American States Ins. Co. v. Hanson Industries*, 873 F.Supp. 17, 23-24 (S.D. Tex. 1995) (exclusion for damages to property sold by insured seller excluded coverage for damage that occurred to claimant after the sale and exclusion for property damage to owned property would exclude damage to the property that occurred while the insured owned it, where damage was limited to the property, itself).

116 *See Gar-Tex Construction Co. v. Employers Cas. Co.*, 771 S.W.2d 639-642 (Tex. Civ. App. – Dallas 1989, writ denied) (insured subcontractor was "in possession of and occupied" the clearwell under construction in determining whether damage occurred during insured's "operations"); *McCord, Condron and McDonald, Inc. v. Twin City Fire Ins. Co.*, 607 S.W.2d 956, 958 (Tex. Civ. App. – Fort Worth 1980, writ ref'd n.r.e.) (insured general contractor of school building was "in possession of and occupied" the building until the general contract was completed).

117 938 F.2d 601, 604 (5th Cir. 1991).

118 Note that the care, custody, or control exclusion in the ISO forms from July 1998 and later applies only to personal property, but the court's analysis in *Cruse* should be relevant in determining whether the insured was "occupying" the property.

foundation subcontractor.[119] The court observed that the homeowners had never surrendered to the insured control of the house and manipulation of the particulars, only the foundation.[120]

The exclusions will also not apply when the third party's property is damaged.[121]

The *Lennar Corp.* court defeated an attempt by an insurer to expand these types of exclusions using varying verb tenses. The insurer claimed that a similar endorsement (Endorsement 2) for property "occupied by, used by, or owned by any Insured," meant property ever owned by them.[122] It pointed to another exclusion B(6)(a) that applied to property you "own, rent or occupy" to state that the different tenses supported its argument, but the Houston court of appeals ruled that the difference was between active and passive voice. It also noted that the title of Endorsement 2 was "Care, Custody, and Control Exclusion," which indicated a desire to exclude coverage for property while it was in the insured's "care, custody, or control," not later.[123] Although the insurer cited two cases that it claimed supported its position,[124] the court ruled that those cases involved damage that occurred while the insureds owned or leased the property even though they no longer owned or leased it when the claims were made.

2. Exclusions (j)(5) and (6) – Damages While Work in Progress

These exclusions exclude coverage for property damage to:

> (5) That particular part of real property on which you or any contractors or subcontractors working directly on your behalf or indirectly are performing operations, if the "property damage" arises out of those operations, or
>
> (6) That particular part of any property that must be restored, repaired or replaced because "your work" was incorrectly performed on it
>
> Paragraphs . . . (5), and (6) of this exclusion do not apply to liability assumed under a side-track agreement.
>
> Paragraph (6) of this exclusion does not apply to "property damage" included in the "products-completed operations hazard."[125]

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119 *Id.* at 604.

120 *Id.*

121 *See Hanson Industries* 873 F.Supp. at 24 and cases cited therein.

122 *Lennar Corp.*, 200 S.W.3d at 692.

123 *Id.*

124 *Dryden Oil Co. of New England, Inc. v. Travelers Indem. Co.*, 91 F.3d 278, 284 (1st Cir. 1986); *Morrone v. Harleysville Mut. Ins. Co.*, 283 N.J.Super. 411, 662 A.2d 562, 565 (Ct. App. Div. 1995).

125 ISO Form CG 00 01 12 04 (2003).

The "products-completed operations hazard" is defined to:

> a. Includes all "bodily injury" and "property damage" occurring away from premises you own or rent and arising out of "your product" or "your work" except:
>
> (1) Products that are still in your physical possession;
>
> (2) Work that has not yet been completed or abandoned. However, "your work" will be deemed completed at the earliest of the following times:
>
> (a) When all of the work called for in your contract has been completed.
>
> (b) When all of the work to be done at the job site has been completed if your contract calls for work at more than one job site.
>
> (c) When that part of the work done at the job site has been put to its intended use by any person or organization other than another contractor or subcontractor working on the same project.
>
> Work that may need service, maintenance, correction, repair or replacement, but which is otherwise complete, will be treated as complete.
>
> *** * ***[126]

a. General matters

The use of the present tense language, "are performing operations," in exclusion (j)(5) means that the damage must occur while the insured or its contractors or subcontractors are currently working on the project, not after the work has been completed.[127]

Exclusion (j)(5) applies only to parts of real property. Improvements to real property, such as permanent structures, are part of the real property. Building components and materials

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[126] ISO Form CG 00 01 12 04 (2003) at V.16.

[127] *Lennar Corp.*, 200 S.W.3d at 686-687; *CU Lloyd's of Texas v. Main Street Homes, Inc.*, 79 S.W.3d at 696.

intended as a permanent part of the building become a part of the improvement once they are installed.[128]

For exclusion (j)(6), you should be aware that the policy's definition of "your work" includes work or operations performed by the insured or on his behalf and the materials, parts, and equipment furnished in connection with such work or operations. It includes warranties or representations made with respect to the fitness, quality, durability, performance, or use of "your work," and the providing of or failure to provide warnings or instructions. Therefore, by definition, "your work" will include the work performed by the named insured and his own employees as well as that performed by his subcontractors and his employees.[129] In addition, "work" includes both labor and the product of the labor.[130]

b. "That particular part" requirement

In addition to the timing factor, the "that particular part" language in subsections (5) and (6) further narrows the scope of these exclusions. Thus, with respect to real property, section (j)(5) operates to exclude damage to the specific area on which the insured (or a subcontractor acting on its behalf) was performing operations, but not to other areas which are damaged as a result.[131] For example, an insured who contracted to repair a swimming pool was not insured for the damage to repair the pool when the pool "popped" out of the ground as it was being drained, but was covered for the consequential damages for costs to repair the homeowner's landscaping, plumbing and deck.[132]

The "that particular part" language includes the entire piece of property on which the insured was working. *See Southwest Tank & Treater Manufacturing Co. v. Mid-Continent Cas. Co.*, 243 F.Supp.2d 597, 604 (E.D. Tex. 2003). Exclusion (j)(6) does not exclude coverage for damage to the insured's non-defective work caused by the defective work for which it does exclude coverage. *Gar-Tex Const. Co. v. Employers Cas. Co.*, 771 S.W.2d 639, 643 (Tex. App. – Dallas 1989, writ denied); *Mid-United Contractors, Inc. v. Providence Lloyds Ins. Co.*, 754 S.W.2d 824, 827 (Tex. App. – Fort Worth 1988, writ denied).

The Missouri Supreme Court interpreted the exclusion in a case where a painter accidentally started a fire that caused extensive damage throughout a house.[133] Immediately

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128 *Sonnier v. Chisholm-Ryder Co., Inc.*, 909 S.W.2d 475, 479 (Tex. 1995).

129 *T.C. Bateson Co. v. Lumbermens Mut. Cas. Co.*, 784 S.W.2d 693, 695-696 (Tex. App. – Houston [14th Dist.] 1989, writ denied).

130 *Id.* at 696.

131 *See Scottsdale Ins. Co. v. Knox Park Const., Inc.*, No. 301CV1852K, 2003 WL 22519536 at *2 (N.D. Tex. 2003); *Southwest Tank and Treater Manufacturing Co. v. Mid-Continent Cas. Co.*, 243 F.Supp.2d 597, 604 (E.D. Tex. 2003).

132 *See American Equity Ins. Co. v. Van Ginhoven*, 788 So.2d 388, 391 (Fla. Ct. App. 2001).

133 *See Columbia Mut. Ins. Co. v. Schauf*, 967 S.W.2d 74 (Mo. 1998).

prior to the fire, the painter had finished painting the kitchen cabinets.[134] The court observed that some courts had interpreted "that particular part" to apply to the subject of the insured's contract, which, in this case, was the entire house; but other courts had held that it applied only to that property on which the insured was actually working at the time of the damage.[135] While both interpretations were reasonable, the latter was more consistent with the intent to circumscribe the scope of the exclusion to "that particular part" of property on which the insured was performing operations.[136] Hence, coverage was negated for the damage to the kitchen cabinets, but not for other damage to the house.[137]

In a case reflecting the contrary view, a Georgia appellate court emphasized that the insured homebuilder was the general contractor and "thus responsible for the entire construction project" in holding that exclusion (j)(5) negated coverage for all damage caused when inadequate tarps on a roof deck allowed the house to become inundated with water.[138]

c. Completed operations coverage

Exclusion (j)(6) does not apply to "property damage" that is included in the "products-completed operations hazard" (quoted above). Therefore, it is important to know when the particular "property damage" occurred in relationship to when the work was completed. Under the policy's definition of "completed operations," "your work" (which includes the work done on behalf of the named insured) will be deemed completed when all of the work called for in the contract has been completed, or when that part of the work done at the job site has been put to its intended use by any person or organization other than another contractor or subcontractor working on the same project, whichever occurs first. The policy specifically provides that work that may need service, maintenance, correction, repair, or replacement, but which is otherwise complete, will be treated as completed. Please note that the fact that the work was defective or still needed to be repaired or replaced will not prevent it from being considered "complete" for purposes of the "products-completed operations hazard" and exclusion (j)(6).

F. Exclusion (l) – Completed Operations

Exclusion (l) addresses the opposite of exclusion (j) with respect to timing, *i.e.*, damage to work that is not discovered until *after* completion of the project. It negates coverage for:

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134 *Id.* at 76.

135 *See id.* at 80-81.

136 *See id.* at 80-81 (narrow interpretation consistent with purpose of business risk exclusions and construction given predecessor "care, custody or control" clause which exclusion (j)(5) replaced).

137 *Id.*

138 *See Bituminous Cas. Corp. v. Northern Ins. Co.*, 548 S.E.2d 495, 498 (Ga. Ct. App. 2001).

(l) Damage to Your Work

> "Property damage" to "your work" arising out of it or any part of it and included in the "products-completed operations hazard".
>
> This exclusion does not apply if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor.[139]

As with exclusion (j), exclusion (l) carves out damage to the particular work performed by the insured, but not the overall damage to property that the incorporation of the defective work causes to other property.[140] Thus, where an insured's defective foundation-leveling services caused damage to the sheetrock, floors, doors, and window sills, the costs to repair such damage were not excluded.[141] Likewise, where defective terrazzo flooring was incorporated into a supermarket, damages for the cost to repair the insured's work were excluded, but damages for diminution in the value of the supermarket were not affected.[142]

1. The subcontractor exception

In combination with exclusion (j), exclusion (l) would negate coverage for most such claims, as "your work" is broadly defined to include work directly performed by the insured and work performed on its behalf. However, the "subcontractor exception," which provides that exclusion (l) does not apply "if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor," may restore coverage.

The articulated rationale of the exception is that a contractor cannot control a subcontractor's negligence as it can its own.[143] The history of the exclusion and this exception is discussed extensively by the *Lennar Corp.* court as part of its discussion that the term "occurrence" must allow potential recovery for construction-defect claims.[144] Other courts, however, hold that the subcontractor exception does not create coverage for construction-defect claims which are not otherwise covered; rather, it merely avoids the effect of exclusion (l).[145]

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139 ISO Form 00 01 12 04 (2003).

140 *See Hartford Cas. Co. v. Cruse*, 938 F.2d 601, 603 (5th Cir. 1991) (applying Texas law).

141 *Id.* at 603-604.

142 *See Missouri Terrazzo Co. v. Iowa Nat'l Mut. Ins. Co.*, 740 F.2d 647 (8th Cir. 1984) (applying Missouri law).

143 *See Fireguard Sprinkler Sys., Inc. v. Scottsdale Ins. Co.*, 864 F.2d 648, 653-654 (9th Cir. 1988) (applying Oregon law).

144 200 S.W.3d at 672-673. *See* §II.A.2, *supra*.

145 *See Travelers Indem. Co. v. Miller Bldg. Corp.*, 142 Fed. Appdx. 147, 149-150 (4th Cir. 2005).

Some courts have held the subcontractor's work does not have to cause the damage for the exception to apply. The Fourth Circuit held that a policyholder could recover for the costs of repairing damages caused by its negligence where the damaged work was performed by a subcontractor.[146] In that case, Limbach Company contracted to install a prefabricated, insulated, underground steam line for Morse Diesel/Essex. Limbach in turn subcontracted with Legacy to excavate the trench for the steam pipe.[147] It was undisputed that Limbach's improper unpackaging of the steam pipe caused a leak in the steam line, which in turn damaged the insulation, backfill around the steam line, and the landscaping in the area.[148] The court held, however, that the cost of repairing the damaged backfill – which backfill work has been performed by Legacy – was not excluded because of the subcontractor exception.[149]

One question that has arisen is whether a supplier or manufacturer constitutes a "subcontractor" for the purposes of this exception. Generally, the courts have asked if the supplier merely supplied a product or if it assumed a portion of the principal contract and whether the product required custom fabrication.[150] The Fourth Circuit, in the *Limbach* case referenced above, determined that the costs of replacing a steam pipe damaged by the policyholder was covered because the pipe was manufactured by a third party, Thermacor.[151] It reversed the district court's holding that Thermacor was a mere "materialman" based on evidence that the pipe was designed in accordance with drawings approved by the policyholder and "custom manufactured" according to those drawings and project specifications.[152]

The *Pine Oak Builders* court held that a carrier had no duty to defend a homeowner's suit because the pleading failed to reference subcontractors – despite the fact that it is virtually certain that the builder employed subcontractors in the construction process.[153] Indeed, in the four other pending cases against the builder alleging similar damages to homes constructed at approximately the same time, the pleadings made express reference to subcontractors.[154] While the court agreed that it was required to resolve any doubt in favor of the insured, as the pleading alleged defective work solely by the insured, it did not create any doubt regarding the applicability of the subcontractor exception.[155]

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146 *Limbach Co. v. Zurich Am. Ins. Co.*, 396 F.3d 358, 363 (4th Cir. 2005) (applying Pennsylvania law).

147 *Id.* at 360.

148 *Id.*

149 *Id.* at 363.

150 *See Limbach Co.*, 396 F.3d at 364.

151 *Id.* at 363.

152 *Id.* at 363-365. Note that the case solely involved the duty to indemnify. *Id.* at 361.

153 2006 WL 1892669 at *6.

154 *Id.* at *4.

155 *Id.* at *5.

The Pennsylvania Superior Court, however placed the burden of proof on the insurer in analyzing a subcontractor exception, observing that where the carrier "ha[s] the burden of proving the applicability of the exclusion, [it] [i]s required to defend [the insured] until facts [ar]e proven at trial to demonstrate the applicability of the exclusion."[156] Accordingly, the court remanded the case for a factual determination of the applicability of the subcontractor exception.[157] Nonetheless, as an exception to an exclusion, carriers should argue that the burden of establishing the subcontractor exception "shifts back" to the insured.

2. Checklist for claims involving insured's faulty work

In summary, the following may be helpful to determining whether, and which, exclusion(s) apply to construction-defect claims involving damage to the insured's work:

- First, when the damage occurred (alternatively, is the damage excluded from the products/completed operations hazard or within the products/completed hazard?)
    - If damage occurs during the construction process, exclusion (j) may apply.
    - If damage does not occur until after the project is complete, exclusion (l) may be applicable.
- Second, are the only damages for the costs to repair the insured's defective work, or are damages also sought for damage to the work of subcontractors or other property?
    - If other work or property is affected, there may be potential coverage for damages associated with that work or property.
    - Was the work performed by a subcontractor?
        - If the only damage is to the insured's work and the damage occurred after construction was completed, there may nonetheless be potential coverage if a subcontractor performed the work on the insured's behalf.

G. Exclusion (k) – Damage to "Your Product"

This short exclusion eliminates coverage for "'property damage' to 'your product' arising out of it or any part of it."[158] "Your product" is defined to include "any goods or products, other

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156 *Kvaerner Metals Div. v. Commercial Union Ins. Co.*, 825 A.2d 641, 651, 658 (Penn. 2003).

157 *Id.* Note that the underlying case had settled, but the insured sought costs it had incurred in defending and settling the action. *See id.* 643 n.2.

158 ISO Form CG 00 01 12 04 (2003).

than real property, that are manufactured, sold, handled, distributed or disposed of" by "you" (the named insured).[159] A building is not a "product"; rather they are constructed or erected.[160] Moreover, the exclusion excludes only damage to the insured's product, not damage caused by the insured's product. Nonetheless, insurers should not overlook the potential applicability of this exclusion in cases where pre-assembled building components, such as windows, are used and are alleged or found to be defective, particularly if the insured sells the same types of units to others.[161] Any damage to the window unit itself may be excluded by this exclusion, if the insured manufactured, sold, handled, or distributed the window units.

H. Exclusion (m) – Impaired Property

Exclusion (m) excludes coverage for damages where there is economic loss caused by defective work but no physical damage. It prevents recovery for:

> "Property damage" to "impaired property" or property that has not been physically injured, arising out of:
>
> (1) A defect, deficiency, inadequacy or dangerous condition in "your product" or "your work"; or
>
> (2) A delay or failure by you or anyone acting on your behalf to perform a contract or agreement in accordance with its terms.
>
> This exclusion does not apply to the loss of use of other property arising out of sudden and accidental physical injury to "your product" or "your work" after it has been put to its intended use.[162]

The term "impaired property" is generally defined as "tangible property, other than 'your product' or 'your work', that cannot be used or is less useful because . . . it incorporates 'your product' or 'your work' that is known or thought to be defective, deficient, inadequate or dangerous . . . *if such property can be restored to use by removal of 'your product' or 'your work.'*"[163]

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[159] *See, e.g., id.* at §V.21.

[160] *CU Lloyds of Texas v. Main Street Homes, Inc.*, 79 S.W.3d 687, 697 (Tex. App. – Austin 2002, n. pet. h.); *Mid-United Contractors, Inc. v. Providence Lloyds Ins. Co.*, 754 S.W.2d 824, 826 (Tex. App. – Fort Worth 1988, writ denied).

[161] This may be useful also if different subsidiaries of a general insured perform different services and "sell" materials between themselves. Even if all are "insureds," the "Separation of Insureds" provision may then operate in favor of the insurer.

[162] ISO Form CG 00 01 12 04 (2003).

[163] *See, e.g.*, ISO Form CG 00 01 12 04 (2003) (emphasis added); *2 Allan D. Windt, Ins. Claims & Disputes*, §11:21 (4th ed. 2005) (*citing Shade Foods, Inc. v. Innovative Prods. Sales & Mktg., Inc.*, 78 Ca. App. 4th 847 (Cal. Ct. App. 2000) ("impaired property" exclusion inapplicable where cereal made with contaminated nuts could not be

Essentially, exclusion (m) is intended to exclude coverage for the costs of repairing or replacing the insured's defective work or product where it has not caused any physical injury but has merely rendered other property less valuable. Courts have equated impaired property with property that may have a lower economic value but is nonetheless functional or usable, such as a car in which the clock has stopped working but is otherwise drivable.[164]

For example, in the *Lennar Corp.* case, an insurer argued that the exclusion applied to replacement of EIFS because the EIFS was not physically injured, but was replaced because it was defective.[165] The court ruled that although the exclusion might apply to replacement of EIFS (particularly as a prophylactic measure), it would not apply to the costs to repair physical injury – water damage – to the homes resulting from the defective EIFS.[166] Even then though, since the entire homes were the insured's work, they were not "impaired property."[167]

The two biggest issues are: (1) whether there has been "sudden and accidental physical injury," and (2) whether the damaged property can be "restored to use." If physical injury arising out of the insured's product or work causes a loss of use of other property, damages may be covered through the exception for "sudden and accidental physical injury."[168] Not surprisingly, the meaning of "sudden and accidental" has been hotly disputed.[169] Some courts have interpreted the exception to require that the other property be rendered inoperable, as opposed to merely less usable.[170]

Moreover, the exclusion will not apply if: (1) mere removal of the insured's product will not alleviate the impairment or (2) the insured's work has been irreversibly incorporated into other work.[171] Thus, it is important to assess whether the insured's work has been so

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"restored to use" by removal of source of contamination; nor was salvage value of damaged cereal equivalent to restoring to use)).

164 *See id., citing Hamlin, Inc. v. Hartford Accident & Indem. Co.*, 86 F.3d 93, 96 (7th Cir. 1996) (applying Wisconsin law).

165 200 S.W.3d at 687.

166 *Id.*

167 *Id.* at 687 n.46.

168 *Gaylord Chem. Corp. v. Propump*, 753 So.2d 349, 355 (La. Ct. App. 2000) (impaired property exclusion only excludes damage to property that has not been physically injured or for which damages are only for loss of use of that property and hence damages based on actual physical injury to claimant's other property not excluded).

169 *Windt, Ins. Claims & Disputes*, §11:21.

170 *See Modern Equip. Co. v. Continental W. Ins. Co.*, 355 F.3d 1125 (8th Cir. 2004) (custom storage rack for meat freezer replaced after multiple collapses of shelves; sudden and accidental exception did not apply where freezer continued to be used albeit at less than optimum capacity).

171 *Federated Mut. Ins. Co. v. Grapevine Excavation, Inc.*, 197 F.3d 720, 728 (5th Cir. 1999).

incorporated or integrated into the whole such that removal or replacement of the insured's work is not feasible or if doing so would itself cause property damage.

Based on these factors, the exclusion is quite convoluted, particularly in the construction-defect context. For this reason, courts are hesitant to rely on the impaired property exclusion as a bar to coverage. For example, in the *Grapevine Excavation* case, the insured's use of improper fill materials in connection with construction of a Wal-Mart parking lot caused damage to the work of the paving subcontractor.[172] The Fifth Circuit noted that rather than removal or replacement of the defective fill, the only proposed means of repairing the lot had been to install an asphalt overlay, leaving both the insured's fill work and that of the paving subcontractor intact.[173] Further, any remedial work to the insured's portion of the project would necessarily have caused physical injury to the paving subcontractor's work.[174] Therefore, the impaired property exclusion did not negate coverage.

Likewise, the Ninth Circuit rejected the impaired property exclusion in a case in which the insured had installed defective concrete piles on a construction project.[175] The insured subsequently installed additional piles, but not before other subcontractors had performed work on the initial defective piles.[176] The re-installation of the insured's concrete piles necessitated the removal and replacement of the work of those subcontractors.[177] The court held that "[t]he destroyed work of other subcontractors was not merely impaired, nor was it restored to use [by the insured's installation of additional piles]," hence the impaired property exclusion was inapplicable.[178]

Such issues indicate the limited applicability of exclusion (m) in traditional construction-defect claims. However, exclusion (m) has been applied to negate coverage in certain construction-related situations, *e.g.*, for remediation costs incurred when a painter's improper removal of lead paint prior to repainting allowed lead paint chips and fumes to enter the house.[179] The court explained that exclusion (m) negates coverage for loss of use claims when (1) the loss of use was caused by the insured's faulty workmanship and (2) there has been no injury to the property other than the incorporation of the faulty work itself.[180] Where the toxins that

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172 *Id.* at 722.

173 *Id.* at 728.

174 *Id.*

175 *Dewitt Constr., Inc. v. Charter Oak Fire Ins. Co.*, 307 F.3d 1127, 1135 (9th Cir. 2002).

176 *Id.* at 1132.

177 *Id.*

178 *Id.* at 1135.

179 *See Dorchester Mut. Fire Ins. Co. v. First Kostas Corp.*, 731 N.E.2d 569 (Mass. Ct. App. 2000).

180 *Id.* at 572.

contaminated the house arose out of the insured's work and that faulty work "denied the owners the use of their house until it could be restored to use by the removal of the faulty element of the contractor's work, the errant chips and dust[,]" the impaired property exclusion negated coverage for the remediation costs.[181]

Exclusion (m) has also had more application outside of the faulty workmanship context, namely with respect to malfunctioning products. For example, exclusion (m) has been held to negate coverage for claims alleging that bugs in AOL software caused interference with the users' operating systems and loss of use of other programs.[182] Similarly, the impaired property exclusion was dispositive in a case in which an insured's defective liquid crystal displays caused the instrument panels in which they were incorporated to malfunction.[183]

I. Exclusion (n) – Recalls ("Sistership Exclusion")

Closely related to repairs for impaired property are costs of repair or replacement of products or work in which a deficiency exists or is merely *suspected*. The exclusion applies to:

> **(n) Recall of Products, Work or Impaired Property**
>
> Damages claimed for any loss, cost or expense incurred by you or others for the loss of use, withdrawal, recall, inspection, repair, replacement, adjustment, removal or disposal of:
>
> (1) "Your product";
>
> (2) "Your work"; or
>
> (3) "Impaired property";
>
> if such product, work, or property is withdrawn or recalled from the market or from use by any person or organization because of a known or suspected defect, deficiency, inadequacy or dangerous condition in it.[184]

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181 *Id.*

182 *See America Online, Inc. v. St. Paul Mercury Ins. Co.*, 347 F.3d 89, 98-99 (4th Cir. 2003) (applying Virginia law).

183 *See Hamlin, Inc. v. Hartford Accident & Indem. Co.*, 86 F.3d 92 (7th Cir. 1996) (defect impaired performance of instrument panels but did not physically injure them).

184 ISO Form CG 00 01 12 04 (2003).

Exclusion (n) excludes coverage for "the cost of preventative or curative action by withdrawal of a product in situations in which a danger is to be apprehended."[185] The recent recall of bagged-leaf spinach is a good example of the type of situation covered by exclusion (n). The exclusion would likely apply to negate coverage for the damages associated with claims by grocers who had purchased the product but subsequently could not sell it.

Exclusion (n) is also relevant to construction-defect claims, as in the *Lennar Corp.* case in which an insured homebuilder removed EIFS products from all houses it had constructed based on complaints from some homeowners of water damage allegedly caused by EIFS. But the court also noted that although exclusion (n) might apply to replacement of EIFS as a preventative measure, it did not extend to the insured's costs to repair water damage caused by EIFS prior to withdrawal.[186]

Nonetheless, courts have generally been reticent to apply the sistership exclusion beyond the recall context. One Texas federal district court recently held that exclusion (n) did not apply to the construction of a building because buildings are generally constructed, not manufactured.[187] Additionally, even if there has been a recall, other factors may preclude application of the exclusion:

- *Did a Third Party Withdraw the Product?* Courts have not applied the sistership exclusion when a party other than the insured pulled the product or work from the market.[188]

- *Did the Product at Issue Prompt the Recall?* If the claim involves the very product that malfunctioned and precipitated the recall, the sistership exclusion does not apply.[189]

J. Other possible important exclusions

1. Exclusion for professional services

Many CGL policies contain the ISO form "Designated Professional Services" exclusion that provides language such as:

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185 *Maryland Cas. Co. v. W.R. Grace & Co.*, 794 F.Supp. 1206, 1227 (S.D.N.Y. 1991), rev'd on other grounds, 23 F.3d 617 (2nd Cir. 1993), *quoting Todd Shipyard Corp. v. Turbine Serv., Inc.*, 674 F.2d 401, 419 (5th Cir.).

186 200 S.W.3d at 687.

187 *Mid-Continent Cas. Co. v. JHP Development, Inc.*, No. SA04CA-192-XR, 2005 WL 1123759 at *8 (W.D. Texas April 21, 2005), *citing Mid-United Contractors, Inc. v. Providence Lloyds Ins. Co.*, 754 S.W.2d 824, 826 (Tex. App. – Fort Worth 1988, writ denied).

188 *Maryland Cas. Co.*, 794 F.Supp. 1206, 1227 (S.D.N.Y. 1991, rev'd on other grounds, 23 F.3d 617 (2nd Cir. 1993).

189 *Gulf Miss. Marine Corp. v. George Engine Co.*, 697 F.2d 668, 674 (5th Cir. 1983) (applying Louisiana law).

> This insurance does not apply to "bodily injury", "property damage" or "personal and advertising injury" due to the rendering of or failure to render any professional service.[190]

The term "professional services" is not defined in this form, which is usually added to the policy as an endorsement, although some manuscript endorsements provide a laundry list of "included" services. "Professional services" is also rarely defined in the body of the CGL policy. Armed with this exclusion, however, some CGL insurers have argued that a contractor or builder is the type of occupation or activity excluded by the "Professional services" endorsement and, therefore, this exclusion applies in construction-defect cases.

There is no Texas authority to support such an argument; rather, Texas cases would support a holding that a contractor or builder does not engage in a "professional service" when it erects, repairs or restores a building.[191] Moreover, if simply engaging in construction activities invokes the application of the "professional services" exclusion, then on what basis did the insurer collect premiums to cover the builder/contractor's liability claims? Such an interpretation of this exclusion might render the policy meaningless to the insured.[192]

2. Exclusions/endorsements tailored to construction-defect claims

In addition to the commonly litigated exclusions discussed above, some carriers have taken an increasingly proactive approach by formulating endorsements that are specifically tailored to construction-defect claims. As discussed above, recent decisions have emphasized the coverage provided through the subcontractor exception the "your work" exclusion. The following endorsement is intended to negate such coverage:

> **EXCLUSION – DAMAGE TO WORK PERFORMED BY SUBCONTRACTORS ON YOUR BEHALF**
>
> This endorsement modifies insurance provided under the following:
>
> COMMERCIAL GENERAL LIABILITY COVERAGE PART

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[190] There are a number of ISO form exclusions, many of which are more specific to particular professions.

[191] *See, e.g., St. Paul Ins. Co. v. Texas Dept. of Transp.*, 999 S.W.2d 881, 886 (Tex. App. – Austin 1999, review denied) (Department of Transportation's allegedly negligent supervision of highway construction that caused flooding was not a "professional service" within the meaning of the professional services exclusion of the highway construction contractor's CGL insurance policy); *Atlantic Lloyd's Ins. Co. v. Susman Godfrey, L.L.P.*, 982 S.W.2d 472, 476 n.3 (Tex. App. – Dallas 1998, pet. denied) ("Previous cases discussing the term 'professional services' most frequently involve medical negligence claims"); *Duncanville Diagnostic Ctr., Inc. v. Atlantic Lloyd's Ins. Co.*, 875 S.W.2d 788, 791 (Tex. App. – Eastland 1994, writ denied) (medical technician's administration of sedative to patient fell within professional services exclusion).

[192] *See St. Paul Ins. Co.*, 999 S.W.2d at 886 (insurer's coverage position would render policy meaningless where it collected a premium for coverage of additional insureds but would interpret its professional services exclusion to exclude all such coverage).

Exclusion 1. of **Section I – Coverage A – Bodily Injury and Property Damage Liability** is replaced by the following:

2. Exclusions

This insurance does not apply to:

l. Damage to Your Work

"Property damage" to "your work" arising out of it or any part of it and included in the products-completed operations hazard".[193]

*** * ***

Another endorsement imposes several conditions on coverage for work that involves the use of subcontractors. It provides as follows:

Subcontractors special condition endorsement:

It is hereby understood and agreed that conditions for coverage under this policy are:

1. Certificates of insurance with limits of liability equal to or greater than those provided by this policy will be obtained from all subcontractors prior to commencement of any work performed for the insured.

2. Insured will obtain hold harmless agreements from subcontractors indemnifying against all losses from the work performed for the insured by any and all subcontractors.

3. Insured will be named as additional insured on all subcontractors general liability policies.

Nothing herein shall be held to vary, alter, waive or extend any of the terms of the conditions, provisions, agreements or limitations of the above mentioned Policy, other than as above stated.[194]

*** * ***

The purpose of these endorsements is obvious – to strengthen the carrier's arguments that a CGL policy does not in fact cover the standard case of defective construction and to more

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193 ISO Properties, Inc., 2000, Form CG 22 94 10 01.

194 *Susan J. Miller & Philip Lefebvre*, 1 Miller's Std. Ins. Policies Ann., Form CGMIS, at 445.5 (4th ed. 2002).

narrowly conscribe the limited coverage available to insureds for unforeseen and unexpected losses.

3. EIFS/mold/lead paint exclusions

Other exclusions are specifically designed to exclude coverage for construction-defect claims involving particular products that have been responsible for large numbers of claims such as EIFS, lead paint, and asbestos, as well as for claims involving mold caused by faulty construction. For example, in the *Pine Oak Builders* case,[195] the policies had very broad EIFS exclusions that also included damage to any "exterior component, fixture, or feature" if EIFS was installed on any portion of that structure. The court enforced the exclusion for all the claims that occurred during a time that the applicable insurer had the exclusion in place.[196]

It is therefore imperative for a party examining the available coverage, if any, to carefully read the entire policy before making assumptions concerning the coverages available for a construction-defect loss.

IV. CONCLUSION

An adjuster should not simply rely on his "gut feel" that a construction-defect case is not covered because the policy is a CGL policy, rather than a performance bond. Although the Texas Supreme Court should soon decide the issue, many Texas courts of appeals are finding that construction-defect cases are "occurrences" and that damage to the actual building is "property damage" that will result in coverage under the policy. This is especially true when the issue is the insurer's duty to defend, which is determined and based on the plaintiff's pleadings and not actual facts to be determined at trial. This does not mean that an adjuster should not consider reserving rights or denying coverage on those bases, but he should be aware that his argument may not ultimately be sustained.

On the other hand, many of the usual exclusions, particularly those related to "business risks," may negate coverage. Moreover, many insurance companies have added additional endorsement exclusions that may apply to a construction-defect coverage case. Accordingly, an adjuster should carefully review the actual policy at issue, if applicable, deny coverage or reserve rights based on the applicable provisions, and be aware of the differing viewpoints expressed in the courts concerning this type of coverage and the exclusions.

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[195] 2006 WL 1892669 at *9-*12.

[196] *Id.* at *12.