

K&LNG Alert

APRIL 2006

Construction/Insurance Coverage Texas Supreme Court to Decide Whether CGL Policies Provide Coverage to Contractors For Property Damage Caused by Construction Defects.

INTRODUCTION

Commercial general liability (“CGL”) policies are an essential part of the insurance portfolio of construction contractors because they cover a broad range of risks incident to building. CGL policies typically obligate the insurer to pay sums the insured becomes legally obligated to pay as damages because of bodily injury or property damage caused by an “occurrence.” Such policies are a principal means of insuring against personal injury and property damage which occur as a result of the contractor’s activities on the job site.

There is currently a controversy raging between insureds and insurance carriers as to whether CGL policies cover property damage (as distinguished from personal injury) resulting from defective construction. Several insureds have recently challenged denials of coverage by CGL carriers in the courts. However, there is a split of authority among courts in different states and even among courts within the same state on this issue.

Texas is one of the states in which its own courts do not agree on this issue. This conflict will likely be resolved soon by the Texas Supreme Court in a case, *Lamar Homes, Inc. v. Mid-Continent Casualty Co.*, that squarely presents this issue. As a result, Texas has an opportunity to definitively decide whether CGL insurance policies governed by Texas law provide coverage for property damage caused by construction defects. How the Texas Supreme Court resolves this dispute may have significant implications for how contractors in Texas manage the risk of construction defects on their projects.

The *Lamar Homes* case has generated a great deal of interest in the construction and insurance industries

both in Texas and nationally. Many industry groups have filed “friend of the court” briefs, including the National Association of Home Builders, Associated General Contractors of America, Texas Association of Builders, the Property Casualty Insurers Association of America and the Complex Insurance Claims Litigation Association. The Texas Supreme Court has an opportunity in *Lamar Homes* to decide whether Texas will follow those courts that have found coverage under CGL policies for damage to a contractor’s own work product as a result of defective construction or whether it will follow the lead of other courts that have held that no such coverage exists.

THE CENTRAL ISSUE IN LAMAR HOMES: IS THERE AN “OCCURRENCE” TRIGGERING COVERAGE?

The *Lamar Homes* case arose from a homeowner suit against a builder. The homeowners alleged the builder was negligent in failing to design and/or construct the foundation of their home in a good and workmanlike manner in accordance with express and implied warranties. The homeowners complained of cracks in the walls, binding doors and excessive deflection of the foundation. After its CGL carrier refused to defend the claim, the homebuilder sued the carrier in federal court. The central issue in the case was whether defects in the homebuilder’s work constituted an “occurrence” triggering the insurer’s duty to defend. Although the case involves residential construction, the issues in dispute in *Lamar Homes* may well apply to commercial construction.

The trial court in *Lamar Homes* held that the purpose of commercial liability insurance coverage for a builder was to protect it from liability resulting from

property damage (or bodily injury) caused by the insured's product, but not for the replacement or repair of that product. The court in its opinion expressed concern that if an insurance policy were to be interpreted as providing coverage for construction deficiencies, it would allow a contractor to receive initial payment for the work from the homeowner, then receive subsequent payment from his insurance company to repair and correct deficiencies in his own work.

Notwithstanding that the plaintiffs alleged the builder was negligent, the court concluded that since the plaintiffs sought recovery of economic loss for damage only to the home, the real basis of their complaint was breach of warranty, i.e., that Lamar Homes did not build the Plaintiffs' home in the fashion and to the standard represented. It thus reasoned that the claim sounded in contract, did not involve an "accident" and thus the CGL policy provided no coverage.

In the ensuing appeal brought by Lamar Homes, the U.S. Court of Appeals for the Fifth Circuit found that the issue at the heart of the case was unsettled under Texas law and thus certified the following questions to be answered by the Texas Supreme Court as the final authority on questions of Texas civil law:

- (1) when a home buyer 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?, and
- (2) when a home buyer 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 defend or indemnify under a CGL policy?¹

"Occurrence" is defined in many CGL policies as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions." Such policies typically do not define the term "accident." This has led to differing interpretations as to what events constitute accidents triggering coverage, thus contributing to the current controversy. The Texas Supreme Court in a previous

case ruled that an injury is "accidental" for purposes of CGL coverage if "from the view point 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."²

In the *Lamar Homes* case before the Texas Supreme Court, the insurer Mid-Continent contended that there is no coverage under a CGL policy for defective workmanship because it is an uninsurable business risk. Arguing that the insured intended to perform the work that resulted in defects, the insurer contended the damages resulted from a breach of contract, not an accident within the scope of coverage. Lamar Homes countered that the language of the policy, which should be the basis for determining whether coverage exists, makes no distinction between contract and tort theories of liability.

While Lamar Homes conceded that coverage does not exist for repair or replacement of the defective work itself, it contended that coverage exists for the property damage done to work other than the defective foundation in the form of cracks in the walls and floors of the house. Lamar Homes argued that because the work was undertaken with the intent to perform it correctly, the consequences of unintended defects are accidental and thus covered. Because building a building is always a volitional act, Lamar Homes contended the test for coverage should be whether the defective work was the result of negligence, as opposed to being intentional.

An analogy that illustrates the builder's position is as follows: that auto insurers do not deny coverage for car accidents on the grounds the accident was caused by the insured's volitional act of driving the car when an unintended consequence of driving, i.e. a crash, occurs. Thus when intentionally performed acts not intended to cause harm nonetheless do so as a result of the insured's negligence, there should be a duty on the part of the insurer to defend. To rule otherwise would render the insurance coverage illusory. Although courts have taken different positions, Lamar Homes has the better argument that construction defects are a covered occurrence provided the defect resulted from negligence and not an intentional tort.

¹ *Lamar Homes v. Mid-Continent Cas. Co.*, 428 F.3d 193, 196-98 (5th Cir. 2005).

² *Mid-Century Ins. Co. v. Lindsey*, 997 S.W. 2d 153, 155 (Tex. 1999).

IS COVERAGE SUBJECT TO AN EXCLUSION?

Although not at issue in *Lamar Homes*, some insurers have also disputed whether, assuming coverage exists under the policy coverage clause, certain exclusions in the CGL policy negate coverage for this type of claim. An exclusion commonly relied upon by carriers in declining to defend an insured is for damage to the builder's own work. Many CGL policies define the insured's own work as (1) work or operations performed by the insured or on its behalf; and (2) materials, parts or equipment furnished in connection with such work or operations and includes warranties or representations made at any time with respect to the fitness, quality, durability, performance or use of the insured's work.

This exclusion is subject to an exception when the work was performed by a subcontractor. However, some carriers eliminate this exception through a new endorsement to the policy. Interestingly, carriers typically acknowledge coverage under subcontractor CGL policies when the subcontractor's work causes damage to work performed by others. However, the same carrier has been known to deny coverage to the general contractor for the same defect on the same job, presumably on the theory that the general contractor's "own work" includes the work performed by all the subcontractors.

Another exclusion commonly relied on by insurers to deny coverage is for damage to real property being worked on if the damage arises out of the work operations. This exclusion applies only while the work is ongoing or to damage discovered while the work is ongoing. Some carriers are deleting this exception by endorsement, thus broadening the exclusion to include damage discovered after the

project is completed. In order to determine just what coverage is being purchased, the contractor must review its policy, including all endorsements, in detail.

CONCLUSION

Only time will tell how the Texas Supreme Court will decide this issue. If *Lamar Homes* prevails and the Court finds coverage for defect claims, contractors should become familiar with the conditions under which such coverage exists and the potential effect of any exclusions so as to take maximum advantage of their insurance coverage.

Should the Court instead decide in favor of the insurer, contractors who rely on their CGL policies to cover the risk that property damage results from defective construction should examine alternative strategies for dealing with this risk. These strategies may include reviewing a new or renewal policy carefully for non-standard provisions and endorsements so as to fully inform themselves about what coverage they are purchasing, taking advantage of the subcontractors' CGL coverage by requiring the general contractor to be listed on their policies as an additional insured, performing all of the work through subcontractors, self-insuring by pricing the work for this risk, and enhanced jobsite inspection and quality-control programs, especially for critical components like the foundation and structure.

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