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Texas Supreme Court Finds Coverage Under CGL Policies for Property Damage Caused by Construction Defects in *Lamar Homes, Inc. v. Mid-Continent Casualty Co.*

Introduction

On August 31, 2007, the Texas Supreme Court issued its long-awaited opinion in *Lamar Homes, Inc. v. Mid-Continent Casualty Co.*,[1] deciding the issue of whether commercial general liability ("CGL") policies provide coverage for property damage caused by defective construction by the policyholder. This issue has been the subject of great controversy not only in Texas but in many other states and has resulted in numerous conflicting judicial decisions. Prior to this decision, there was a split of authority within the Texas Courts of Appeal, several of which have issued diametrically opposed rulings. That controversy has now been resolved, at least within the State of Texas, by the Texas Supreme Court's answers in *Lamar Homes* to certified questions from the United States Fifth Circuit Court of Appeals. In a well-reasoned opinion, the Texas Supreme Court ruled that unintended construction defects may constitute an "accident" or "occurrence" under a CGL policy and that resulting damage to or loss of use of the home may constitute "property damage" sufficient to trigger a duty to defend by the insurer.

Discussion

The *Lamar Homes* case arose from a homeowner's 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 damage to the builder's work consisting of cracks in the sheetrock walls and stone veneer and excess deflection of the foundation. After its CGL insurer refused to defend the claim, the home builder sued the insurer in federal court. The central issues in the case were whether defects in the home builder's work constituted an "accident" or "occurrence" triggering the insurer's duty to defend and whether damage to or loss of use of the home constituted "property damage" within the meaning of the policy.

The federal district court in *Lamar Homes*[2] upheld the insurer's denial of coverage, concluding that the insurer had no duty to defend the builder for construction errors that harmed only Lamar Homes' own product. The district court reasoned that a CGL policy's purpose is "to protect the policyholder from liability resulting from property damage (or bodily injury) caused by the policyholder's product, but not for the replacement or repair of that product."[3] The district court held that defects in construction could be an "occurrence" under the policy only when the defect caused bodily injury or damage to property of a third party, neither of which was alleged in *Lamar Homes*.

On appeal, the Fifth Circuit noted disagreement among the Texas Courts of Appeal about the application of the CGL policy in the context of construction defect claims and thus certified the following questions to the Texas Supreme Court:

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?

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?

3. If the answers to certified questions (1) and (2) are answered in the affirmative, does Article 21.55 of the Texas Insurance Code apply to a CGL insurer's breach of the duty to defend?

A. Unintended Construction Defects May Constitute an "Accident" or "Occurrence" under a CGL Policy

The Supreme Court answered the first question affirmatively based on a reading of the CGL policy. The Court found no logical basis within the policy definition of "occurrence" to distinguish between damage to the policyholder's work and damage to a third party's property, as held by the district court. An "occurrence" depends on the fortuitous nature of the event, that is whether the damage was expected or intended from the standpoint of the policyholder. The Court found that the complaint alleged an "occurrence" because it asserted that Lamar Homes' defective construction was a product of its negligence, not that it intended or expected its work or its subcontractor's work to damage the home. Since the Court thus found that an "occurrence" had been alleged, it then turned to the question of whether defective construction or faulty workmanship damaging only the general contractor's work is "property damage" within the meaning of the CGL policy.

B. Damage to or Loss of Use of the Home May Constitute "Property Damage" Sufficient to Trigger a Duty to Defend

The Court also answered the Fifth Circuit's second question yes, based on the CGL policy definition of "property damage" as "[p]hysical injury to tangible property, including all resulting loss of use of that property." The Court found that the plaintiffs' allegations of cracking sheetrock and stone veneer were clearly allegations of "physical injury" to "tangible property." It rejected the district court's reasoning that damage to the home builder's own work cannot be "property damage" because CGL insurance exists not to repair or replace the policyholder's defective work and that such an interpretation transforms CGL insurance into a performance bond. The Court found that any similarity between CGL insurance and a performance bond was irrelevant because "[n]o rule of construction operates to eliminate coverage simply because similar protection may be available through another insurance product."[4]

The Texas Supreme Court also rejected the insurer's argument that the economic-loss rule means that damage to the policyholder's own work is not "property damage" but rather a contractual, economic loss. The Court held that the economic-loss rule is a liability defense or remedies doctrine and not a useful tool for determining insurance coverage. It found that the CGL policy made no distinction between tort and contract damages; it simply asks whether "property damage" has been caused by an "occurrence." Rejecting an argument by the dissent that "property damage" means only tort damages, the Court stated that "Texas law, however, requires that insurance policies be written in English, preferably plain English, not code."[5] Under the policy language, the label attached to the cause of action, "whether tort, contract or warranty--does not determine the duty to defend."[6] Thus, the proper inquiry is whether an "occurrence" has caused "property damage," not whether the ultimate remedy for that claim lies in contract or in tort.

C. Applicability of the Prompt Payment of Claims Statute to an Insurer's Duty to Defend

The Fifth Circuit certified a third question to the Texas Supreme Court concerning the applicability of Article 21.55 of the Texas Insurance Code, now Texas Insurance Code §§ 542.051-061. This statute makes an insurer, which is liable for a claim under an insurance policy and which does not promptly respond to or pay the claim responsible to pay the policyholder or beneficiary interest on the amount of the claim, at the rate of 18% per year as damages, together with reasonable attorney's fees. Noting that some courts have declined to apply the prompt-

payment statute to a defense benefit because it is a service, not a sum certain, and is not ordinarily paid directly to the policyholder, the Court held that such a construction would eliminate much of the statute's recognized application, such as to health insurance claims, property damage claims and claims personal to the policyholder under an auto policy. The Court ruled that the statute applied to duty-to-defend benefits, with the liability for interest accruing upon the date the policyholder paid each bill for attorney's fees. Thus CGL insurers that do not promptly provide a defense to policyholders when coverage exists will be liable for the statutory penalties.

Conclusion

Although *Lamar Homes* is a major victory for policyholders seeking coverage under CGL policies, limitations remain on the scope of CGL coverage for construction defects. For example, even under the Court's ruling, intended or expected losses would not fall within the definition of "accident" or "occurrence." Additionally, certain contractually-assumed liabilities, obligations under worker's compensation and related laws, injury and damage arising out of aircraft and automobiles, pollution-related claims and other business risks may be specifically excluded in most CGL policies. The Court gave policy exclusions j(5) and j(6) as examples. Exclusion j(5) eliminates coverage for "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 these operations." Exclusion j(6) excludes coverage for "that particular part of any property that must be restored, repaired or replaced because 'your work' was incorrectly performed on it."

The standard-form CGL policy provides an exception to the "your-work" exclusion when a general contractor becomes liable for damage to work performed by a subcontractor, or for damage to the general contractor's own work arising out of a subcontractor's work. As a result of the *Lamar Homes* decision, it is possible that insurers in the future may delete the subcontractor exception from the policy, thereby limiting coverage for construction defects under the "your-work" exclusion. Thus it is important that policyholders become familiar with all coverage provisions and exclusions when purchasing or renewing CGL coverage to understand the scope of coverage being purchased.

Notes:

1. No. 05-0832, available at http://www.supreme.courts.state.tx.us/opinions/HTMLOpinionInfo.asp?OpinionID=2001020.

2. 335 F.2d 754 (N.D. Tex. 2004).

3. *Id*. at 759.

4. Opinion at 12.

5. *Id*. at 17.

6. *Id*. at 18.

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