CASE NO. 05-0832

IN THE SUPREME COURT OF TEXAS

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LAMAR HOMES, INC.,

*Appellant,*

v.

MID-CONTINENT CASUALTY COMPANY,

*Appellee.*

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CASE NO. 04-51074
CERTIFIED QUESTION FROM
THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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# BRIEF OF AMICI CURIAE, ASSOCIATED GENERAL CONTRACTORS OF AMERICA, TEXAS BUILDING BRANCH – ASSOCIATED GENERAL CONTRACTORS OF AMERICA, AMERICAN SUBCONTRACTORS ASSOCIATION, INC., ASA OF TEXAS, INC., ASSOCIATED PLUMBING – HEATING – COOLING CONTRACTORS OF TEXAS, INC., AND PLUMBING – HEATING – COOLING CONTRACTORS – NATIONAL ASSOCIATION

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## STATEMENT OF INTEREST OF AMICI CURIAE

This Amici Curiae brief speaks for the national and state chapters of three of the largest construction trade associations in the United States. The sponsorship of these national organizations, in addition to their Texas Chapters, underscores the importance of the insurance coverage issues to be addressed by the Court in this proceeding for Texas and national construction businesses alike..

The Associated General Contractors of America (AGCA) is the oldest and the largest of nationwide associations representing construction contractors. AGCA was formed in 1918 and it represents more than 32,000 firms in nearly 100 chapters throughout the United States. Among the association's members are more than 7,000 of the nation's leading general contractors, more than 11,000 specialty contractors, and more than 13,000 material suppliers and service providers to the construction industry. The association's members engage in the construction of office buildings, apartments, condominiums, shopping centers, factories, warehouses, highways, bridges, tunnels, airports and water works facilities, and site utilities necessary for housing development.

The Texas Building Branch of the Associated General Contractors of America ("TBB–AGC") is a branch of AGCA. TBB–AGC is comprised of eleven AGCA building chapters located throughout the State of Texas. The membership of these eleven chapters consists of approximately 370 general contractors and 3,890 specialty contractors, subcontractors and suppliers, all doing business in Texas.

American Subcontractors Association, Inc. ("ASA") is a non-profit corporation supported by the membership dues paid by approximately 5,000 members nationally.

ASA of Texas, Inc. serves as a statewide organization for 500 Texas members in six local chapters in Austin, El Paso, Houston, North Texas, Rio Grande Valley, and San Antonio. The majority of ASA member businesses are subcontractors and suppliers.

The Plumbing-Heating-Cooling Contractors National Association ("PHCC–National") was founded in 1883 and is the largest trade association in the plumbing-heating-cooling industry. PHCC–National's membership is composed of 5,000 firms nationwide, performing all types of work from residential and commercial to industrial and institutional. The Associated Plumbing-Heating-Cooling Contractors of Texas, Inc. ("APHCC–Tx") is a non-profit Texas association of approximately 300 plumbing, heating and cooling contractor professionals and firms operating in the state of Texas. These firms comprise about 30,000 people, including employees. APHCC–Tx was founded in 1889.

Because of their unique perspectives as influential representatives of broad segments of the construction industry, these organizations have all submitted amicus curiae briefs in numerous jurisdictions. Moreover, they have a great interest in the many risks that inhere in the construction process, and insurance has long played an important role for their members in managing those risks. Whether AGC, ASA, or APHCC members can depend on their general liability insurance policies to provide some reasonable degree of protection against financial harm is a matter of continuing and urgent interest to the members of all of these organizations. Consequently, though Amici Curiae are not parties to this appeal, this brief was filed by Amici Curiae through the undersigned independent counsel, who was paid a fee by them for its preparation.

## CERTIFIED QUESTIONS PRESENTED

1. 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?

2. 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 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?[1]

## INTRODUCTION

Amici Curiae, as well as other businesses engaged in construction within the State of Texas, confront the questions certified to this Court in managing the considerable risks associated with building construction. While Texas contractors and subcontractors strive, and usually succeed, in providing quality construction services to owners and upper tier contractors, occasionally inadvertent mistakes occur, mistakes that can result in defects in construction. Texas contractors have always paid substantial premiums for liability insurance to provide protection from liability for the property damage arising out of these defects. The arguments made by Mid-Continent Casualty Company ("Mid-Continent") in this case call for a radical departure from traditional means of providing insurance coverage for construction defect risks, by virtually eliminating that coverage. These insurers seek to do so without even revising or changing the insurance policy forms that

[1] While Amici Curiae have limited their arguments in this brief to Questions 1 and 2, they support and adopt Lamar's position that Article 21.55 of the Texas Insurance Code applies to a CGL insurer's breach of its duty to defend.

have been in use for decades. It is this threat that has united AGC, ASA and APHCC, in submitting this brief in support of the position of Appellant, Lamar Homes, Inc. ("Lamar") and urging the Court to answer all three certified questions in the affirmative.

The first two certified questions before this Court crystallize the studied attempt of Mid-Continent to rewrite and significantly reduce the coverage provided by the standard commercial general liability ("CGL") insurance policy. That type of policy insures nearly all participants in the construction industry, including general contractors, homebuilders, subcontractors and material and equipment suppliers, together with all other parties that are affected by defective construction.[2] These parties include project owners, both public and private, as well as homeowners. The construction industry is one of the driving forces behind the economic well-being of this state and this nation, but at the same time, construction – whether residential, commercial or public – is an endeavor fraught with huge risks, risks the dollar amount of which often exceeds the value of the project itself. For that reason, commercial insurance has historically been a critical element of any construction project whereby substantial exposures are insured against in exchange for significant premiums.

Generally, buildings and other improvements are built pursuant to contracts in which the contractor or subcontractor obligates itself to construct the project in accordance with the plans and specifications. Thus, one of the risks is that the project will not be built according to those plans and specifications, resulting in construction

[2] For simplicity's sake, the analysis in this brief often uses the generic term "contractor" or "builder." This term includes subcontractors and other participants in the construction industry, unless otherwise indicated.

defects. Some risks of defective workmanship are insurable. Contrary to the strained arguments of Mid-Continent, a construction defect that causes property damage that is neither expected nor intended is, and always has been, an "occurrence" under Texas insurance law. Amici Curiae do not contend that every construction defect is an "occurrence," the repair of which is insured under a CGL policy. Obviously, intentionally sloppy or shoddy workmanship that damages a project is not an "occurrence." But at the same time, simply because the performance of faulty workmanship may breach the construction contract, it does not follow that the property damage resulting from that faulty workmanship is, to use the terminology employed in the policy itself and as used by this Court in *King v. Dallas Fire Ins. Co.*, ***"expected or intended from the standpoint of the insured."*** Certainly, those damages are not by definition foreseeable for purposes of CGL coverage as Mid-Continent contends.

The novel interpretation of the definition of "occurrence" argued by Mid-Continent before this Court is a clear departure from the interpretation of coverage as marketed by the insurance industry to purchasers of CGL policies, including thousands of AGC, ASA and APHCC members in Texas and nationally. That marketing emphasizes the availability of coverage for various categories of defective work, including property damage arising out of the work of the insured's subcontractor. This coverage is accomplished through an intricate series of exclusions directed primarily at service providers such as contractors and subcontractors.

If property damage to a home or a project arising out of defective work can never constitute an "occurrence," then policy provisions are rendered mere surplusage by the

argument of Mid-Continent. At the same time, basic tenets of insurance policy contract interpretation are violated. Unlike Mid-Continent's argument that would require this Court to deep-six the terms of the policy itself in favor of vague principles of inapplicable law, Amici Curiae ask nothing from this Court but to apply the language of the CGL policy in answering the certified questions before it.

## SUMMARY OF THE ARGUMENT

The arguments of Mid-Continent suffer from a fatal flaw in that they do not address, in fact they virtually ignore, the very terms of the CGL policy under which they are seeking to evade their obligations. If this Court were to accept such arguments, it would be placed in the anomalous position of interpreting a standard form contract in use throughout the state of Texas, and throughout the United States, without giving due consideration to the terms of that standard contract itself. Such an interpretation would be contrary to Texas contract law, as applied to insurance policies, in which the Court is to interpret the contract so as to give effect to all provisions of the contract.

Mid-Continent's arguments that forsake the terms of its standard CGL policy and the response of Amici Curiae to them, include:

- *A CGL policy distinguishes between liability and tort versus liability and breach of contract*. It does not.

- *Property damage to the project flowing from a breach of contract is foreseeable and not an "occurrence" under the CGL policy*. Simply because the damage is to the subject matter of the contract, it does not follow that it was expected or intended, and thus not an "occurrence" under Texas law.

- *The economic loss rule determines coverage under a CGL policy.* The economic loss rule is a liability defense and has no effect whatsoever on

whether the property damage is unexpected and unintended, and thus an "occurrence" under the policy.

- *Damages flowing from defective work in breach of a construction contract are necessarily an uninsured economic loss.* Many damages arising out of defective work performed in breach of a contract cause physical injury to tangible property, including damage to other elements of the work, and thus satisfy the definition of "property damage" under the CGL policy.

- *Upholding coverage for property damage arising out of defective work transforms the CGL policy into a performance bond.* "Occurrences" of unexpected and unintended property damage may trigger both the policy and the bond and, due to the inherent differences between the CGL policy and the performance bond, the CGL policy ultimately provides coverage in those instances. A CGL policy never functions as a performance bond.

- *Defective workmanship is an uninsurable business risk.* The business risk of shoddy workmanship by an insured builder is carefully circumscribed by other provisions in the policy, most notably exclusions that are tailored specifically to service industries such as construction. Thus, a certain degree of coverage is provided for "business risks."

- *Coverage for an insured builder for its subcontractor's work cannot be created by an exception to an exclusion.* The provision in Exclusion (l) that states that the exclusion does not apply where the work was performed by a subcontractor does not create coverage; rather, it simply preserves coverage that is provided for in the initial coverage grant of the policy for an "occurrence" of unexpected and unintended property damage.

By presenting these arguments in isolation from the policy terms, Mid-Continent tries to avoid the effect of the carefully drafted policy exclusions since those exclusions place limits on the general notion that a CGL policy does not cover a builder's risk of faulty work. The coverage dispute underlying the certified questions before this Court presents a textbook example of how the property damage exclusions tailor the coverage for insured contractors and subcontractors, entitling them to coverage for carefully

defined business risks, including defective workmanship performed by their subcontractors. Therefore, Amici Curiae ask this Court to do nothing more but read and apply the express terms of that policy, and as a result, to answer Certified Questions 1 and 2 affirmatively.

## ARGUMENT

Mid-Continent's attempts to reduce coverage through policy interpretation arguments bereft of the language of the policy itself cannot be sanctioned by this Court. While Mid-Continent has cited case law from other jurisdictions that it claims supports its position, this Court should not engage in the truncated review of the policy to reach the same result as those courts. Under Texas law, an incomplete analysis of the CGL policy written by Mid-Continent is impermissible, in that an insurance contract, like any other contract, must be interpreted so as to give meaning to all of its provisions. *Kelley-Coppedge, Inc. v. Highlands Ins. Co.*, 980 S.W.2d 462 (Tex. 1998).

It is little wonder why Mid-Continent tries to "cut the policy off at the knees," and to ignore the property damage exclusions, especially where a claim involves property damage arising out of the work of the insured's subcontractors. That is exactly the case presented to the Court in this dispute. Acceptance of Mid-Continent's arguments prevents the application of the carefully tailored property damage exclusions that are designed to provide insured builders with coverage for the property damage arising out of their subcontractors' work. The intent behind the enhanced coverage for insured contractors for property damage arising out of their subcontractors' work is discussed later in this brief.

## I. THE PERFORMANCE OF DEFECTIVE WORK IN BREACH OF A CONSTRUCTION CONTRACT CAN INVOLVE AN "OCCURRENCE" OF UNEXPECTED AND UNINTENDED "PROPERTY DAMAGE"

Mid-Continent's attempt to deny coverage for defective work claims based upon an incomplete analysis of "occurrence" raises three types of arguments. Those arguments include (a) a distinction between tort versus breach of contract for purposes of coverage; (b) that property damage arising from defective work in breach of a contract is foreseeable, and thus cannot constitute an "occurrence;" and (c) that the economic loss rule dictates that all damages arising from defective work constitute economic damages for breach of contract, and not property damage. All of these arguments suffer from essentially the same basic flaw: whether the damage arises out of a breach of contract is irrelevant for coverage under a CGL policy since the policy makes no distinction between tort and breach of contract damages.

The focus for satisfaction of the insuring agreement of the CGL policy is a legal obligation on the part of the insured builder to pay the damages caused by property damage arising out of an "occurrence", that is property damage that is neither expected nor intended from the standpoint of the insured builder. Moreover, under Texas law, the focus is not upon the intentional nature of the actions that result in property damage, but rather, upon the unexpected nature of the damages themselves. Surely Mid-Continent does not contend that every construction default involves an expected or intended breach of contract by its insured. If that is in fact Mid-Continent's argument, it exhibits a

misunderstanding of the construction industry that it seeks to insure.[3] Despite the best of efforts, on some occasions, work is performed incorrectly, and that work results in property damage. That type of property damage, unless excluded by the property damage exclusions under the policy, is covered under a CGL policy.

### A. The CGL Policy Does Not Distinguish Between Tort Versus Breach of Contract Damages

The undercurrent of Mid-Continent's entire argument as to the meaning of "occurrence" is the fact that liability of an insured builder for property damage caused by defective work involves a breach of contract. Since virtually the entire construction industry at any level – owner, general contractor or homebuilder, subcontractor, sub-subcontractor, or material supplier – does business based on written contracts, if that argument were to succeed, a CGL policy would be of much less utility to the construction industry.[4] Fortunately, the arguments raised by insurers on these issues cannot survive scrutiny when compared with the language of the CGL policies that they themselves

[3] Mid-Continent's brief is rife with misunderstandings or misstatements as to how the construction industry does business. For example, Mid-Continent claims that where a contractor repairs its property damage caused by its defective work, it "gets paid twice." Nothing could be further from the truth. While a contractor is paid for the original construction, it is obligated in its contract to repair the defective workmanship at its own cost (or suffer a lawsuit). Those repairs constitute the measure of damages for which the contractor is legally obligated to pay because of "property damage," within the terms of the insurance policy. Alternatively, if suit is filed by the owner against the contractor, the damages are determined by the finder of fact. The insurance indemnifies the contractor for the cost of repair or the damages assessed against it. Such a result is particularly appropriate where, as in this case, the property damage was caused by subcontractors. In addition, Mid-Continent claims that a finding of coverage will require the insurer to pay for minor punch list work at the close-out of a project. Again, this argument is simply untrue. "Punchlist" work is within the insured contractor's original contract, the repair of which does not entitle it to additional compensation.

[4] Mid-Continent, at page 14 of its brief, claims that it cannot be the "intent of the parties" that it should pay millions of dollars in defective work claims in exchange for what it regards as a relatively minor premium. Setting aside the fact that the "intent" of insured builders in purchasing CGL policies is largely irrelevant due to the adhesionary nature of the CGL policy forms forced upon by them by Mid-Continent, if Mid-Continent were to succeed in its occurrence argument, it would appear that the premium charged by Mid-Continent for its policy issued to Lamar would be excessive to say the least.

write because CGL policies do not distinguish between liability in tort over breach of contract. For example, since an "occurrence" involves injury that is unexpected or unintended from the standpoint of the insured, many torts, such as intentional torts, are not "occurrences." At the same time, inadvertent breaches of contract can result in property damage neither expected nor intended by the insured. There is simply no bright line of demarcation, either in the policy language or under Texas law.

In *Venture Encoding Service, Inc. v. Atlantic Mutual*, 107 S.W.3d 729 (Tex.App. – Fort Worth 2003, pet. denied), the insuring agreement of the insurance policy stated that the insured would pay those sums that the insured becomes legally obligated to pay as damages ..." *Id.* at 734. Venture, the insured, misprinted and mailed out payment books to borrowers of Sallie Mae. Discovering its defective work, it reprinted and remailed the corrected books to the borrowers. Atlantic, the insurer, claimed that Venture was not "legally obligated" to incur the repair costs since it constituted a contractual obligation. The court looked to the contract between Venture and Sallie Mae to determine that Venture was contractually obligated to meet quality control standards and stated as follows:

> Because the insured had a legal obligation under the terms of its contract with Sallie Mae to remedy and correct any mistakes or errors in printing services, we conclude appellant's damages are sums that the insured incurred in correcting a mistake or deficiency in covered products or printing services. We also conclude that this insured was legally obligated to pay or incur the expenses necessary to remedy the misprinted books.

*Id.* at 737. Likewise, builders have a legal obligation under the terms of their contracts with owners to remedy the defective work of themselves and their subcontractors.

Other Texas courts have refused to be taken in by the false tort versus contract dichotomy. In *Ins. Co. of N. America v. McCarthy Bros. Co.*, 123 F.Supp.2d 373 (S.D.Tex. 2000), the contractor constructed a hospital, and the roof leaked. The contractor settled the lawsuit filed by the hospital, agreeing to make repairs for $25,000. The leakage was actually much more extensive and it refused to honor the agreement. The hospital then sued the contractor for breach of the settlement agreement and the contractor's CGL insurer denied a defense and coverage, claiming that breach of contract was not covered. Applying Texas law, the court rejected this argument as "clever but incorrect," noting that under Texas law, it is the facts, not the theories of liability, that govern. *Id.* at 377. For the same proposition, see the seminal case of *Vandenberg v. Centennial Ins. Co.*, 982 P.2d 229, 244 (Cal. 1999)(expressly overruling prior California precedent and holding that "[t]he nature of the damage and the risk involved, in light of particular policy provisions, control coverage," based upon the understanding of a reasonable layperson reading the policy).

One of the most recent cases to consider this issue on substantially identical facts, and to reject the distinction between liability in tort versus contract for purposes of CGL coverage is *Broadmoor Anderson v. National Union Fire Ins. Co. of La.*, 912 So.2d 400 (La.App. 2d Cir. 2005), application filed. In that case, T-Z, a subcontractor to Broadmoor, the insured general contractor, installed the shower pan assemblies in the guest rooms in a hotel-casino. The assemblies leaked after completion, damaging other finishes and building components including the stalls themselves, interior finishes, drywall and carpets. Broadmoor supervised and paid for the repairs, and made a claim on

the CGL policy insuring the project. As does Mid-Continent in this case, the insurer argued that the insured's contractual obligation to repair the damage to the guest rooms did not give rise to an insured accident or "occurrence" under the policy. The court resoundingly rejected this argument, stating as follows:

> This policy language for the CGL grant of coverage does not make any express distinction between tort or contractual liability. While the term "accident" may imply a tortious event, T-Z's deficient conduct, unexpected and with lack of foresight, can also be considered accidental.

*Id.* at 405. The court looked to the products-completed operations coverage under the policy to support its holding. Products-completed operations, as discussed below, is the coverage component under a CGL policy that insures against bodily injury and property damage occurring after the project is completed and turned over to the owner. In that regard, the *Broadmoor* court's reasoning is worth quoting at length:

> Although a collapse of a building structure long after completion of the project might cause bodily injury to a third party and be a covered accident arising in tort, the contemplated hazard as defined in the policy also indicates coverage for property damage relating to the deficient performance of the contractor that harms the structure and its owner and therefore entails a contractual breach. Also, there is no limitation in all of the provisions discussed so far regarding who may suffer damage and be a beneficiary of the policy coverage, whether a third party or the insured's contracting partner.

*Id.* For another case relied upon by the *Broadmoor* court in its "occurrence" analysis, s*ee American Family Mut. Ins. Co v. American Girl, Inc.*, 673 N.W.2d 65,77 (Wis. 2004)(nothing in the CGL policy supports any definitive tort/contract line of demarcation).

As the *Broadmoor* court held, neither the definitions of "occurrence," "accident" nor the "products-completed operations hazard" support a distinction between tort liability to third parties and the insured's liability to the owner for breach of contract relating to property damage to the project arising out of the defective work of its subcontractors. The court then went on to consider the effect of policy exclusions on coverage for the insured contractor's costs of repair. This Court should do the same.

Commentary from the insurance industry itself establishes that no "tort versus breach of contract" dichotomy was contemplated for purposes of the coverage grant under the CGL policy. The landmark commentary by George H. Tinker, the Associate General Counsel of Kemper Insurance Companies, on the 1973 CGL policy form revisions makes clear the intent of the drafters that breach of contract damages are covered:

> The coverage agreement embraces 'all sums which the insured shall become legally obligated to pay as damages…' That portion of the coverage grant is intentionally broad enough to include the insured's obligation to pay damages for breach of contract as well as for tort, within limitations imposed by other terms of the coverage agreement (e.g., bodily injury and property damage as defined, caused by an "occurrence") and by the exclusions …

George H. Tinker, *Comprehensive General Liability Insurance—Perspective and Overview*, 25 FED. INS. COUN. Q. 217, 265 (1975), excerpts attached at Tab 1. The coverage grant in the current edition of the standard CGL policy, including the policy before this Court, is virtually unchanged from the 1973 revision.

There is no basis under the policy language to accept the argument that the coverage grant in a CGL policy includes only tort and not breach of contract damages,

including a breach that obligates the insured builder to repair or correct defective work on the home or project that was unexpected or unintended. While all such damages may not eventually be covered, that determination must be made by careful consideration of the policy exclusions, exclusions that Mid-Continent has not even bothered to argue. Where defective work of subcontractors to the named insured is involved, the exclusions usually do not apply and a builder such as Lamar is entitled to coverage, including damage to its own work. It is little wonder that Mid-Continent presses arguments that seek to divert the attention of courts, including this Court, from the very terms of their policies that are intended to address construction risks. Such an anomalous result is contrary to all rules of insurance policy interpretation and should be avoided.

### B. Unexpected And Unintended Property Damage To A Construction Project Arising Out Of Defective Work Is Not Foreseeable

Mid-Continent argues that simply because direct damages arising out of a breach of contract are presumed to be foreseeable, they *ipso facto* cannot constitute an "occurrence" under a CGL policy issued to a construction contractor. In making this argument, Mid-Continent goes to great lengths to convince this Court to forsake its own prior pronouncement on what constitutes an "occurrence" as defined in the standard form CGL policy that is again before it today.

That pronouncement was made in *King v. Dallas Fire Ins. Co.*, 85 S.W.2d 185 (Tex. 2002), in which this Court upheld the existence of an "occurrence" as to causes of action for negligent hiring, training, and supervision against King, the insured employer, and arising out of his employee's assault of a third party. Based on the standard

definition of "occurrence" as contained in the CGL policy, this Court determined that these allegations were to be evaluated from the standpoint of King, the insured; and because King neither intended nor expected the injury, an accident occurred, and Dallas Fire's duty to defend was triggered.

The Texas Supreme Court's opinion in *King* is the most comprehensive treatment of "occurrence" under the CGL policy form currently in use throughout the State of Texas and involved in this dispute. In addition to the definition of "occurrence", the Court looked to Exclusion (a) of the policy, which states that the insurance does not apply to bodily injury or property damage that is expected or intended from the standpoint of the insured. This Court's deference to the drafting history of the "occurrence" definition coupled with this exclusion is worth quoting at length:

> The definition of 'occurrence' in CGL policies in 1966 read: 'Occurrence' means an accident, including continuous or repeated exposure to substantially the same general harmful condition, which results in bodily injury or property damage neither expected nor intended from the standpoint of the insured.'... The 1966 revisions eliminated the possibility that policies would be construed from the victim's point of view and mandated that occurrence be determined from the *standpoint of the insured.*
>
> In 1986, the CGL form was again modified. The language "expected or intended from the standpoint of the insured" was removed from the definition of "occurrence" and reinserted as an exclusion from coverage. The reason for the 1986 modification was so that courts would not be forced to construe the definition of "occurrence" as if it were an exclusion. Instead, the 1986 revision creates an express exclusion for intentional acts. And whether the act was intentional was to be determined from the 'standpoint of the insured.'…From our review of *Appleman* [HOLMES' APPLEMAN ON INSURANCE §117.5 at 392 (2000)], *we* note that there is a relationship between the policy's definition of 'occurrence' and the exclusion for intentional acts. *Appleman* [*Id.*, §117.1, at 217; *Id.* §117.5 at 392], in fact, suggests that the 1986 redraft was designed to shift the intentional injury inquiry into an exclusion. As well, the construction given

> to the word "occurrence" by Dallas Fire renders the exclusion for intended injury surplusage. [Emphasis in original, footnotes omitted.]

*Id.* at 192-193.

The opinion reaffirms the existence of an "occurrence" under a CGL policy where the resulting property damage or bodily injury is neither expected nor intended. The Court was also troubled by the insurer's narrow reading of the definition of "occurrence," a reading that "…obviates the need for many other standard exclusions often contained in CGL policies." *Id.* at 193. Likewise, Mid-Continent's reading of the definition of "occurrence" obviates the need for numerous policy provisions, including, in addition to Exclusion (a), Exclusions (j), (k), (m) and (n). In light of Mid-Continent's unduly narrow definition of "occurrence," the certified questions before this Court can be reduced to one: "Who needs exclusions?"

*King* has been consistently applied in the construction defect context. In *Archon Investments, Inc. v. Great American Lloyds Ins. Co.*, 174 S.W.3d 334 (Tex. App. – Houston [1st Dist.] 2005, pet. filed), Great American, a related company to Mid-Continent, argued that there was no "occurrence" or coverage for the costs of repairing or replacing the insured homebuilder's own work. Following *King*, the court held that whether an injury is accidental is determined from the standpoint of the insured, and since the insured builder could not have intended that the negligent work of its subcontractors caused physical damage to the home, there had been an "occurrence." *Id.* at 340.

The court also found an "occurrence" arising out of defective work in *Lennar*

*Corp. v. Great American Ins. Co.*, 2005 WL 1324833 (Tex. App. – Houston [14th Dist.] June 2, 2005). Lennar built hundreds of homes using synthetic stucco, or EIFS. They leaked and eventually Lennar was required to replace the EIFS with stucco and to repair the water damage. Lennar argued that there had been an "occurrence" on the basis that it did not intend or expect the property damage to the homes resulting from its application of EIFS and in response, its insurers argued there could be no "occurrence" as a matter of law essentially since the insured's work was performed pursuant to contract. The court rejected this argument, relying on authorities such as *King v. Dallas Fire, supra*, to hold that the relevant inquiry was not whether the insured damaged its own work, i.e., whether the claim sounded in contract only, but whether the resulting damage was expected or intended from the standpoint of the insured. *Lennar* at *9.

Another recent opinion rejecting similar arguments, again made by Mid-Continent itself, is *Mid-Continent Cas. Co. v. JHP Development, Inc.*, 2005 WL 112375 (W.D. Tex. April 21, 2005), appeal pending. That case involved the defective construction of a condominium project by the insured builder, JHP. In its typical fashion, Mid-Continent, the CGL insurer, argued that "JHP's work was voluntary and intentional, and therefore not a covered 'occurrence.'" *Id.* at *2. Judge Xavier Rodriguez cited to *King v. Dallas Fire* for the proposition that it is the insured's standpoint that controls in determining whether there has been an "occurrence" and because there was no allegation that the insured intentionally caused the water damage, there was an "occurrence." *Id.* at *4. *See also, Gehan Homes, Ltd., v. Employers Mut. Cas. Co.*, 146 S.W.3d 833 (Tex. App. – Dallas 2004, pet. filed)(applying *King Fire* to find an "occurrence," in the face of the

argument that there was no "occurrence" because the damage was to the subject of the contract, since the builder neither expected nor intended the resulting property damage to the home's foundation). *Id.* at 843.[5]

This Court has already affirmed that, under the terms of the standard CGL policy, the inquiry as to the existence of an "occurrence" begins and ends with whether the property damage is expected or intended from the standpoint of the insured. In light of its holding in *King*, Question 1, as certified by the Fifth Circuit, has in effect already been answered by this Court. The issue under a CGL policy is not the foreseeability of damages as some element of a cause of action for breach of contract; rather the issue is whether that property damage is expected or intended from the standpoint of the insured builder. Builders typically do not intend to perform their work defectively. To argue otherwise, as Mid-Continent does before this Court, illustrates either a serious lack of understanding of, or a callous disregard for, the construction industry it purports to insure.

### C. The Economic Loss Rule Does Not Affect CGL Coverage For Unexpected And Unintended Property Damage Arising Out of Defective Work

The flawed assumption on the part of Mid-Continent, that a CGL policy does not apply to property damage involving a breach of contract, results in a confusing mishmash

[5] It should be noted that *King v. Dallas Fire* was not a departure from prior Texas case law on occurrence. In fact, it mirrors earlier cases addressing insurance coverage for faulty workmanship, including *Hartford Cas. Co. v. Cruse*, 938 F.2d 601, 605 (5th Cir. 1991)(occurrence takes place where the resulting injury or damage was unexpected or unintended, regardless of whether the insured's actions were intentional); *Travelers Ins. Co. v. Volentine*, 578 S.W.2d 501 (Tex. Civ. App. – Texarkana 1979, no writ) (insured mechanic's defective performance of valve job resulting in destruction of entire engine; even though defective, performance of the work itself might not be an accident, destruction of the entire engine was certainly unexpected and unintended).

of concepts borrowed from the substantive law and which add nothing to the coverage analysis under a CGL policy. As set out above, to boldly pronounce that all property damage arising out of the performance of defective work is foreseeable, and outside the realm of "occurrence," emasculates the policy language. The same is true with the argument that application of the economic loss rule thrusts unexpected and unintended property damage outside the definition of "occurrence". It does not, and this argument is yet another example of Mid-Continent's effort to evade the language of its own policy.

Insurers have plucked and then seized upon this argument from substantive products liability law for the proposition that when the injury is the economic loss to the subject of a contract itself, the action sounds in contract alone. The consequence is that a tort action, usually one for negligence, is barred. Mid-Continent's favorite cases in this regard are *Nobility Homes of Texas, Inc. v. Shivers*, 557 S.W.2d 77 (Tex. 1977) and *Jim Walter Homes, Inc. v. Reed*, 711 S.W.2d 617 (Tex. 1986), both of which are products liability cases involving manufactured or prefabricated homes, i.e. manufactured homes and not homes or complex construction projects individually constructed through the provision of construction services by construction contractors or builders.[6]

Mid-Continent's argument is confused in its attempt to mix apples with oranges. The economic loss rule is a liability defense or remedies doctrine, and it is not dispositive

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[6] A construction project, whether it be a retail building, an office building or a home is not a "product" under a CGL policy. The term "your product" is defined in the policy to exclude real property, a revision that was added in 1986 to make it clear that a building project is not the product of the insured builder. Thus, Exclusion (k),excluding coverage for property damage arising out of the named insured's product, does not apply to the typical construction defect claim, including the one that is the subject of the certified questions at hand. *See also, Mid-United Contractors, Inc. v. Providence Lloyds' Ins. Co.*, 754 S.W.2d 824 (Tex.App. – Fort Worth 1998, writ denied)

of insurance coverage. The rule is centered around the determination of whether the injury is to the subject of the contract itself. In contrast, the existence of an "occurrence" of property damage under the express language of the CGL policy is centered around the determination of whether the claim involves "physical injury to tangible property" that is neither expected nor intended from the standpoint of the insured. Any notion of whether the unexpected and unintended physical injury to tangible property is to the subject matter of the contract does not enter the coverage mix ***until*** the property damage exclusions are considered. Even then, the notion of the "subject of the contract" is a foreign concept, with the major issue for determination being whether the injury arises out of the insured's work, or the work of a subcontractor. In other words, the property damage exclusions may deny coverage for some, but not all, elements of the work that are the subject of the contract. Here, Mid-Continent has chosen not to rely on any policy exclusions in denying Lamar's claim.

Mid-Continent ignores the fact that many types of damage arising out of defective work, though they can run afoul of the economic loss rule, still satisfy the definitions of "occurrence" and property damage" in the CGL policy. Obviously, "physical injury to tangible property" can occur to a construction project, the subject of the contract between the insured contractor and the owner. For example, consider a home that is subject to water infiltration due to defective installation of the windows and exterior cladding. Water infiltrates the home and causes damage to interior finishes, rotting of the wooden

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(rejecting contention of insurer that construction project is insured contractor's "product" under prior edition of CGL policy).

structural members and mold, requiring that the home be torn down and rebuilt. Obviously, there has been "physical injury to tangible property," i.e. the home, but at the same time, that home is the subject of the contract between the homebuilder and the homeowner. At that point, there has clearly been an "occurrence" of "property damage" as those terms are defined in the policy, and resort must be had to the property damage exclusions to determine the precise scope of coverage. The extensive cracking of the DiMare home caused by the alleged defects in the foundation constitutes "physical injury to tangible property." Mid-Continent cannot change that fact by calling it economic loss through bending a doctrine that has no place in insurance coverage.

In making this tongue-in-cheek argument, Mid-Continent engages in the same conduct of which it accuses Lamar (and that it apparently deplores). Mid-Continent makes much of the fact that application of the economic loss rule eliminates a negligence cause of action for the same conduct. At numerous other points in its brief, it argues that a court should not accept the legal theories asserted, but rather the factual allegations. That statement of Texas law cannot be argued with, and so it is quite mystifying why Mid-Continent attaches so much significance to the elimination of the negligence cause of action by applying its economic loss rule. If in fact Mid-Continent focuses on the nature of the allegations against its insured, it is clear that those factual allegations set out physical injury to tangible property that was unexpected and unintended, an "occurrence" of "property damage" under the CGL policy. Regardless of the outside-the-policy moniker Mid-Continent chooses to employ – economic loss, subject matter of the contract, or foreseeable contract damages – these damages are within the definitions of

"occurrence" and "property damage" regardless of the legal theory plead against the insured.

Besides the district court's opinion in *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 335 F.Supp.2d 754 (W.D. Tex. 2004), there is precious little support for application of the economic loss rule in an insurance coverage context. In fact the opinion has been roundly criticized and rejected by other courts. For example, in *Archon Investments v. Great American, supra,* 174 S.W.3d at 141, the court rejected the applicability of the economic loss analysis of the lower court to determine an insurer's duty to defend the underlying lawsuit, largely since it is a liability defense or remedies doctrine and not supported by the policy language. The court in *Archon* specifically declined to extend Mid-Continent's economic loss rationale of *Jim Walter Homes, supra,* to the determination of a CGL insurer's duty to defend a builder in a construction defect case.

In another case from the same district, Judge Rodriguez refused to follow *Lamar Homes* and accept Mid-Continent's economic loss rule justification for its denial of a defense to its insured builder, in favor of cases upholding "occurrences" under similar circumstances, including *King. Mid-Continent v. JHP Development, supra,* 2005 WL 1123759 at *2-*4. The Fourteenth District has summed up the reasons for its rejection of cases such as *Lamar Homes* as follows:

> [W]e agree that the relevant inquiry is not whether the insured damaged its own work . . . i.e., whether the claim sounds in contract only. We conclude that defective construction resulting in damage to the insured's own work can constitute an 'occurrence' as long as the resulting damage was unintended and unexpected.

*Lennar Corp. v. Great American, supra,* 2005 WL 1324833 at *9.

Courts in other states have also criticized and rejected the economic loss rule argument of Mid-Continent. In *American Family Mut. v. American Girl, supra,* 673 N.W.2d 65, the owner sought recovery from the general contractor for damage to a warehouse resulting from settlement of the foundation which resulted in sinking, buckling, and cracking of the warehouse structure. In response to the claim, the insurer characterized the claim as one for economic loss rather than property damage, and argued that the economic loss doctrine barred coverage. The Wisconsin Supreme Court stated that even though the economic loss doctrine restricted the owner's recovery to specific warranties in the construction contract, there was no basis for the insurer's argument that a loss giving rise to a breach of contract or warranty claim categorically could never constitute "property damage" within the meaning of the CGL policy's coverage grant. The court determined that, under the circumstances of an "occurrence" of physical injury to tangible property, the CGL insuring agreement provided coverage for the claim, a claim for "property damage" within the meaning of the policy. The court's analysis is worth quoting at length:

> The economic loss doctrine operates to restrict contracting parties to contract rather than tort remedies for recovery of economic losses associated with the special contract relationship… The economic loss doctrine is a remedies principle. It determines how a loss can be recovered – in tort or in contract/warranty law. It does not determine whether an insurance policy covers a claim, which depends instead upon the policy language.
>
> The economic loss doctrine may indeed preclude tort recovery here (the underlying claim is in arbitration not before us); regardless, everyone agrees that the loss remains actionable in contract, pursuant to specific warranties in the construction agreement between Pleasant [the owner] and Renschler [the insured contractor]. To the extent that American Family

> [the insurer] is arguing categorically that a loss giving rise to a breach of contract or warranty claim can *never* constitute 'property damage' within the meaning of the CGL's coverage grant, we disagree.

*Id.* at 75.

In light of the common sense policy-based approach of the Wisconsin Supreme Court, it is little wonder that Texas courts, such as the Fourteenth Court of Appeals, have relied extensively on *American Girl* to reject Mid-Continent's economic loss argument. *Lennar Corp. v. Great American* at *9-*10.[7] For another case in which a court rejected the application of the economic loss rule to deny coverage for a defective construction claim on a CGL policy, *see, Commercial Union Ins. Co. v. Roxborough Village Joint Venture*, 944 F.Supp. 827, 832 (D.Colo. 1996) (finding use of the rule in the insurance context "troublesome," and rejecting the tort versus contract distinction).

All of these authorities reject the applicability of an economic loss rule analysis to coverage under the CGL policy for a defective work claim because such an analysis impermissibly mixes liability and coverage concepts. Even more impermissibly, the application of the rule in that manner emasculates the policy language.

### D. Texas Insurance Law On "Pure" Economic Loss Does Not Apply Here

Mid-Continent also supports its argument that there was no property damage to the home under its policy by citing a string of Texas cases for the proposition that a CGL

[7] In light of the persuasive analysis of the Wisconsin Supreme Court, Mid-Continent, at page 40 of its brief, is left with quoting a scenario from the dissent in that case. *American Girl*, 673 N.W.2d at 93. Of course, the dissent represents only the minority of the Wisconsin Supreme Court, much in the same manner that Mid-Continent's position represents only the minority view on this issue. Contrary to Mid-Continent's argument, neither Lamar nor Amici Curiae claim that the property damage exclusions will serve no purpose in the event that property damage to the insured's own work can never be an occurrence. Rather, the position of Lamar and Amici Curiae is that such property damage is caused by an occurrence and as such, the property damage exclusions must be considered in order to make a coverage determination as to that type of claim, as is the case with other claims.

policy does not cover economic loss. This effort simply clouds the issue by calling the physical injury to the home – cracking exterior stone veneer, cracking dry wall, ill-fitting doors, and a heaving foundation – something else, i.e. economic loss.

Mid-Continent is obviously correct that the CGL policy does not cover "pure" economic loss. The problem with the case law it cites is that, unlike the claim before this Court, the damages in those cases involved actual economic losses, and not physical injury to tangible property. For example, *see, State Farm Lloyds v. Kessler*, 932 S.W.2d 732 (Tex.App.–Fort Worth 1996, writ denied) (economic damages due to misrepresentation of sellers under homeowner's policy as to no drainage and foundation problems); *Terra Int.'l, Inc. v. Commonwealth Lloyd's Ins. Co.*, 829 S.W.2d 270 (Tex.App. – Dallas 1992, writ denied) (fraudulent misrepresentations as to property located in flood control district after discovery that property was rendered worthless); *Houston Petroleum Co. v. Highlands Ins. Co.*, 830 S.W.2d 153 (Tex.App.–Houston [1st District] 1991, writ denied) (loss of capital contributions and investment in limited partnership venture); *Lay v. Aetna Ins. Co.*, 599 S.W.2d 684 (Tex.App.–Austin 1980, writ ref'd n.r.e.) (economic loss from negligent failure to locate an oil well on land was not physical injury to tangible property); *Great Am. Lloyds Ins. Co. v. Mittlestadt*, 109 S.W.3d 784 (Tex.App.–Fort Worth 2003, no pet.) (inability to sell home due to encroachment on pipeline easement).

In another attempt to salvage its economic loss argument, Mid-Continent yet again cites to products liability cases for the unremarkable proposition, ***under products liability law,*** that where there is no physical injury to persons and property, injury to the defective

product is an economic loss. Those cases include *Mid-Continent Aircraft Corp. v. Curry County Spraying Serv., Inc.*, 572 S.W.2d 308 (Tex. 1978)(rebuilt airplane bought "as is" with no implied warranties of merchantability and fitness); *Two Rivers Co. v. Curtiss Breeding Serv.*, 624 F.2d 1242 (5th Cir. 1980)(loss of reputation of cattle herd as a result of genetically abnormal bull semen); *Rocky Mountain Helicopters, Inc. v. Bell Helicopter Co.*, 491 F.Supp. 611 (N.D. Tex. 1979) (interpreting express or implied warranties as to manufacture of helicopter). As previously discussed, none of these cases involve insurance coverage under a CGL policy, let alone physical injury to tangible property, and they simply stand for the proposition that there is no coverage under a CGL policy for economic loss in the absence of physical injury to tangible property. Where there has been physical injury to tangible property, the notion of economic loss simply is not in play. As such, this precedent actually supports coverage for the property damage arising out of the foundation of the home that is the subject of this action.[8]

### E. Mid-Continent's Foreign Authorities Are Not Persuasive

Mid-Continent cites to foreign case law to support its contention that defective workmanship claims involving damage only to the subject of the insured's contract are not accidental and that defective workmanship cannot be an "occurrence". A good number of these cases are from jurisdictions where the development of the case law on

[8] Numerous Texas courts have held that damages to homes that are the subject of the contract between the builder and the homeowner, including cases involving construction defect damages similar to those before this Court, constitute "physical injury to tangible property." Those cases include *Home Owners Management Enterprises, Inc. v. Mid-Continent Cas. Co.*, 2005 WL 2452859 at *7 (N.D. Tex. Oct. 3, 2005) (damages awarded for repairs necessitated by faulty foundation, including potential foundation and replacement and cracks in the walls and slab constitute "property damage"); *Lennar Corp. v. Great American, supra*, 2005 WL 1324833 at *13; *Gehan Homes v. Employers Mut., supra*, 146 S.W.3d at 843, 844; *Archon Investments v. Great American, supra*; *First Texas Homes,*

the "unexpected and unintended" nature of the property damage is not as well developed as in Texas. Alternatively, some of these cases simply do not involve "occurrences" of property damage; rather, they involve pure breaches of contract. For example, *see*, *Webster County Solid Waste Authority v. Brackenrich & Associates, Inc.*, 617 S.E.2d 851 (W.Va. 2005); *Diamond State Ins. Co. v. Chester-Jensen Co., Inc.*, 611 N.E.2d 1083 (Ill.App. 1993); *American State Ins. Co. v. Mathis*, 974 S.W.2d 647 (Mo.App. 1998).

Moreover, the *American State v. Mathis* case, and its companion case, *Hawkeye Security Ins. Co. v. Davis*, 6 S.W.3d 419 (Mo.App. 1999), are both cited by Mid-Continent for the assertion that a breach of a contractual duty cannot fall within the term "accident" and that a failure to perform cannot be described as an undesigned or unexpected event. Though a bold statement, this assertion is quite naturally tempered under subsequent Missouri case law. A very recent example is *Amerisure Mut. Ins. Co. v. Paric Corp.*, 2005 WL 2708873 (E.D. Mo. Oct. 21, 2005). In that case, the court refused to woodenly follow *American State v. Mathis* and *Hawkeye Security v. Davis* where a subcontractor to the insured contractor had installed leaking EIFS on several hotel projects. The court observed that courts interpreting Missouri law have looked to a number of factors in determining whether a case involves an unintended "occurrence" and accident. Those factors include:

- whether an undesigned or unexpected event occurred;
- whether the alleged "occurrence" was a business risk not covered by the CGL policy;

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*Inc. v. Mid-Continent Cas. Co.*, 2001 WL 238112 (N.D. Tex. Mar. 7, 2001), *aff'd*, 2002 WL 334705 (5th Cir. 2002) at *3; *Luxury Living, Inc. v. Mid-Continent Cas. Co.*, 2003 WL 22116202 (S.D.Tex. Sept. 10, 2003).

- whether excluding the alleged "occurrence" from coverage essentially left the insured without any coverage;
- whether, if the liability policy were construed to cover only accidents not involving breach of warranty and negligence, no protection would be given the insured;
- whether performance of the contract was within the insured contractor's control and management;
- whether the property damage was the result of the work of a subcontractor; and
- whether the contractor simply failed to perform the contract.

*Id.* at *5. Based on those factors, the court was persuaded that the construction defect petitions in the underlying actions against the insured contractor alleged the possibility of an "occurrence", thus, upholding the duty to defend. *Id.* at *6. As can be seen, even in jurisdictions paying lip service to extreme statements including "breach of contract as no "occurrence," the analysis, on a case-by-case basis, involves many factors, including the unexpected and undesigned nature of the property damage.

For a further example, Mid-Continent cites *L-J, Inc. v. Bituminous Fire & Marine Ins. Co.*, 621 S.E.2d 33 (S.C. 2005) for the proposition that "faulty construction claims allege no occurrence." Subsequent case law applying South Carolina law indicates that such an interpretation is overly broad. In *Okatie Hotel Group, LLC v. Amerisure Ins. Co.*, 2006 WL 91577 (D.S.C. 2006), decided only three weeks prior to the filing of this brief, the court limited the court's holding in *L-J* to the situation where there was no property damage beyond the damage to the work product or the improper performance of the task itself. That case involved extensive moisture damage to a hotel constructed by the insured contractor. The court stated that "although damage to the work product alone, caused by faulty workmanship, does not constitute an 'occurrence,' the property damage

to Plaintiff's [the owner's] hotel – caused by exposure to the harmful condition of leaks and moisture – constituted an 'occurrence' under the CGL policies."

Thus, the sweeping holdings that Mid-Continent attributes to many of its cases are frequently scaled back in practice based upon the facts surrounding a particular claim. The O*katie* court limited the scope of *L-J* to only the defective work product itself, and not damage to the rest of the project, that is, the hotel. This result coincides with property damage exclusions in the policy such as Exclusions j(5) and j(6), exclusions that are limited to only the "particular part" of property upon which the insured is performing operations, or which must be repaired or replaced due to the named insured failing to perform its work correctly upon it. These exclusions would serve little purpose if damage beyond the defective item of the work were not an "occurrence." While Amicus Curiae do not agree with the *L-J* holding as to "occurrence," the case before this Court presents a scenario similar to that faced by the court in *Okatie*, that is, where the property damage extends beyond the defective item of work, i.e. the foundation itself, to portions of the home that were otherwise not defective. That damage is covered under *Okatie.*

Finally, in *Heile v. Herrmann*, 736 N.E2d 566, 567 – 568 (Ohio App. 1999), the court appeared to default to an incomplete "occurrence" analysis, rather than interpret what it termed to be an insurance policy "riddled with definitions, exclusions, exceptions, exceptions to exclusions, and exclusions to exceptions." This Court should not engage in such a truncated analysis as employed in *Heile* and similar cases, especially where, as here, the damages caused by the alleged defective foundation caused additional damage to materials and finishes throughout the home. Only through an interpretation of the

entire policy, even one riddled with terms, conditions, exclusions, and exceptions, can this Court determine the coverage owed to Lamar, the insured builder.

## II. THE CGL POLICY COVERS UNEXPECTED AND UNINTENDED PROPERTY DAMAGE ARISING OUT OF THE WORK OF SUBCONTRACTORS TO THE NAMED INSURED

Mid-Continent's fixation on "occurrence" and accident is no accident in and of itself. Mid-Continent seeks to avoid any rational discussion of the effect upon defective work claims of the exclusions contained in the CGL policy. The obvious reason is that Exclusion (1), the "your work exclusion," actually preserves coverage under the facts of this case. Briefly, that exclusion states that the insurance does not apply to:

> '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.

The exclusion denies coverage for property damage to "your work," a term that is defined in relevant part under the CGL policy as "work or operations performed by you or on your behalf; and materials, parts or equipment furnished in connection with such work or operations." The terms "you" and "your" refer to the named insured builder under the policy. Moreover, the exclusion only applies to property damage that is included in the "products-completed operations hazard," defined, in relevant part, to include bodily injury and property damage arising out of the insured's work, except for work that has not yet been completed or abandoned. Work is 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 the owner. Here, there is no dispute that the DiMares home, at the time the property damage occurred, was a "completed operation," since all work had been completed under Lamar's contract and the home had been put to its intended use.

The your work exclusion may deny coverage for property damage to Lamar's own work on the home. Nevertheless, that exclusion does not apply to this claim, because of the second sentence of the exclusion. That provision explicitly states that the exclusion does not affect coverage where the damage arises out of work performed by a subcontractor on behalf of the named insured.[9]

### A. Case Law Upholds Coverage For Property Damage Arising Out Of Subcontractor Work

The intent to provide coverage to an insured contractor for property damage arising out of the defective work of its subcontractors is recognized by the courts, including, of course, the courts of Texas. The most recent precedent on this issue, *Lennar Corp. v. Great American Ins. Co., supra*, 2005 WL 1324833, and *Archon Investments, Inc. v. Great American Lloyds Ins. Co., supra*, 174 S.W.3d 334, recognize the profound effect of the subcontractor exception upon coverage for a defective workmanship claim against a contractor. As discussed above, the courts in *Lennar* and *Archon* refused to accept the insurer's restrictive definition of "occurrence," largely because of the coverage provided for contractors by virtue of the subcontractor exception

[9] Many subcontractors, in turn, subcontract out a portion of their work to lower tier subcontractors, sometimes referred to as sub-subcontractors. These subcontractors also benefit from the coverage provided by the subcontractor provision.

to Exclusion (l). Those courts concluded that coverage is not precluded when the work was performed by subcontractors. *Archon,* at 341-342; *Lennar, supra,* 2005 WL 1324833, at *12. The *Lennar* court summarizes as follows:

> In the cases cited here by the carriers, the courts generally relied on the 'business risk' doctrine to conclude that defective construction cannot constitute an 'occurrence.' However, those courts have not acknowledged what several other jurisdictions have appropriately recognized: (1) insurers ordinarily eliminate coverage for "business risks" through exclusions – not through the definition of 'occurrence'; and (2) coverage for "business risks" is not necessarily precluded when the damaged work, or the work out of which the damage arose, was performed by subcontractors.

*Lennar*, at *9. *See, also, First Texas Homes, Inc. v. Mid-Continent* C*as. Co.*, *supra,* 2001 WL 238112 (upholding the subcontractor provision to preserve coverage to insured homebuilders for property damage arising out of the work of structural engineer/subcontractor that designed defective foundation); *CU Lloyds of Texas v. Main Street Homes, Inc.*, 79 S.W.3d 687 (Tex. App. – Austin 2002, no pet.) (a plain reading of the exclusion demonstrated that the subcontractor provision applied and the exclusion did not preclude coverage for defective foundations designed by a subcontractor to the homebuilder); *Mid-United Contractors, Inc. v. Providence Lloyds Ins. Co.*, 754 S.W.2d 824 (Tex. App. – Fort Worth 1988, writ denied) (subcontractor provision contained in the 1973 edition of the CGL policy applied to preserve coverage for the insured general contractor for property damage to masonry panels installed by subcontractor).

One of the clearest judicial statements of the intent to provide this coverage is set out by the court in *O'Shaugnessy v. Smuckler Corp.*, 543 N.W.2d 99 (Minn. App. 1996), *review denied* (Minn. Mar. 28, 1996). In that case, the insured homebuilder constructed a

home with all of the actual work being performed by subcontractors. Defects in the home surfaced after completion. In specifically addressing the application of the subcontractor provision to the claim, the court stated as follows:

> Here, we are faced not with an omission, but an affirmative statement on the part of those who drafted the policy language, asserting that the exclusion does not apply to damages arising out of the work of a subcontractor. ***It would be willful and perverse for this court simply to ignore the exception that has now been added to the exclusion.*** [Emphasis added.]

*Id.* at 104. Likewise, it is willful and perverse for Mid-Continent to ask this Court to ignore the same subcontractor provision in the Mid-Continent policy.

Another recent case, *American Family Mut. v. American Girl*, *supra*, sets out the broadening effect of the subcontractor provision. There, the court applied the plain language of the policy, upholding coverage under circumstances substantially similar to this case. There, a subcontractor gave Renschler, the insured general contractor, faulty site preparation advice, resulting in excessive settlement and eventual demolition of a warehouse. The Wisconsin Supreme Court upheld coverage for the property damage attributable to the actions of the subcontractor, stating as follows:

> This subcontractor exception dates to the 1986 revision of the standard CGL policy form. Prior to 1986 the CGL business risk exclusions operated collectively to preclude coverage for damage to construction projects caused by subcontractors. Many contractors were unhappy with this state of affairs, since more and more projects were being completed with the help of subcontractors. In response to this changing reality, insurers began to offer coverage for damage caused by subcontractors through an endorsement to the CGL known as the Broad Form Property Damage Endorsement, or BFPDE. Introduced in 1976, the BFPDE deleted several portions from the business risk exclusions and replaced them with more specific exclusions that effectively broadened coverage. Among other changes, the BFPDE extended coverage to property damage caused by the

> work of subcontractors. In 1986 the insurance industry incorporated this aspect of the BFPDE directly into the CGL itself by inserting the subcontractor exception to the "your work" exclusion.

*Id.* at 82-83. In support of its holding, the Wisconsin Supreme Court relied upon case law from other states, including the Texas case, *CU Lloyds of Texas v. Main Street Homes, Inc., supra*. *See also, Wanzek Constr., Inc. v. Employers Ins. of Wausau*, 679 N.W.2d 322 (Minn. 2004) (rejecting business risk doctrine and upholding coverage under subcontractor provision of Exclusion (l)).

All of the prerequisites for the application of the subcontractor provision to the property damage caused to the DiMare home apply here and cannot be ignored. That property damage occurred after completion and arose out of the work of subcontractors and coverage for that exposure is preserved under the your work exclusion.

### B. The Historical Development of the Subcontractor Provision Establishes Coverage Under the Mid-Continent Policy

This Court should not depart from the plain language of the Mid-Continent policy in favor of Mid-Continent's reliance on overly broad platitudes such as "a CGL policy is not a performance bond" or that a CGL policy is not intended to cover any cost of defective construction. Many of the cases in this area address the issue in terms of "business risk," in that a CGL policy is not designed to cover an insured's ordinary business risks, including a contractor's own defective construction. Obviously, that doctrine has some support in insurance underwriting, case law interpreting older policy forms and common sense. Nevertheless, that doctrine is carefully circumscribed and limited in the 1986 CGL policy form upon which the Mid-Continent policy is written.

A historical tension has existed between CGL coverage for defective construction work and what insurance underwriters have traditionally referred to as an uninsured "business risk." This tension gained momentum with the 1966 revisions to the CGL form promulgated by the Insurance Services Office ("ISO"), the industry organization responsible for drafting the industry-wide standard forms used by insurers. The 1966 revisions separated the exclusion for property damage arising out of work performed by the named insured from the exclusion for property damage arising out of the named insured's products. Then, in 1973, ISO promulgated the Broad Form Property Damage Endorsement ("BFPDE") to the standard policy form. That endorsement expanded the coverage under the 1973 form by modifying the "work performed" exclusion to delete the exclusion for work performed "on behalf of" the named insured, so as to provide an insured contractor with coverage for property damage arising out of the defective work of its subcontractors. The only caveat was that the property damage must occur after the completion of the work. *See,* J. D. O'Connor, *What Every Construction Lawyer Should Know About CGL Coverage for Defective Construction,* 21 WTR CONST. LAW. 15, 16 (2001) (available on Westlaw).

The Fort Worth Court of Appeals, in *Mid-United Contractors, Inc. v. Providence Lloyds Ins. Co., supra,* upheld the underwriting intent behind the deletion of property damage arising out of the work of subcontractors from the work performed exclusion of the 1973 BFPDE, finding coverage for the insured general contractor for damage to masonry panels caused by its subcontractor. Not surprisingly, Mid-Continent does not rely upon *Mid-United Contractors,* and in contrast, other Texas precedent cited by it in

support of its position that CGL policies are not intended to cover faulty workmanship did not involve CGL policies containing the expanded coverage accomplished through the BFPDE. *See, T.C. Bateson Constr. Co. v. Lumbermens Mut. Cas. Co.,* 784 S.W.2d 692 (Tex. App.–Houston [14th Dist.] 1989, writ denied). As such, the policy in *T.C. Bateson* did not include broadened coverage provided through the modification of the your work exclusion to preserve coverage for property damage related to subcontractor work, as does the policy before this Court.

The Mid-Continent policy is written on a form that was revised in 1986, and through those revisions to the CGL form, ISO sought to clarify the limitations on the business risk concept previously introduced in 1973 by the BFPDE. Due to the popularity of the extra coverage provided by the BFPDE, one major revision was the insertion of the subcontractor provision into Exclusion (l), the your work exclusion, in the standard coverage of the policy. That revision clarified the existence of completed operations coverage for property damage arising out the work of subcontractors.

The notion that a CGL policy should not cover a contractor's business risk of defective construction may have a proper, but limited place in the analysis of insurance coverage under a CGL policy. It may contribute to the rationale behind the coverage, but any coverage analysis must begin and end at the same point: the plain language of the policy. That recognition is in full accord with the intent of the drafters of the policy. George Tinker's landmark commentary, published shortly after the 1973 revisions to the CGL policy were promulgated, stated as follows:

> The foregoing is designed to be a descriptive, not a definitive, treatment of an important underwriting concept [the business risk doctrine]. It is recognized that regardless of what concepts underwriters may employ and regardless of what their intent may be, the scope of coverage is found in the four corners of the contract. Nonetheless, an awareness of the business risk concept helps to give dimension and understanding to some of the key provisions of the policy.

G. H. Tinker, *Comprehensive General Liability Insurance–Perspective and Overview*, *supra,* at 226, attached at Tab A.

Thus, even the drafters of the 1973 revisions of the CGL policy recognized that the policy language itself shapes and limits underwriting concepts such as the business risk doctrine. That is exactly what the subcontractor provision in the your work exclusion on the 1986 form accomplishes, as did the predecessor BFPDE attached to the 1973 form. They circumscribe and limit the business risk concept and Mid-Continent cannot now evade that coverage by borrowing sweeping concepts from contract or products liability law to redefine the intent behind the standard policy term upon which its own policy is written.

### C. The Subcontractor Provision Preserves Existing Coverage From Exclusion

Mid-Continent argues that applying the explicit terms of the subcontractor provision in this case amounts to an impermissible creation of coverage by an exclusion. It is nothing of the kind. This line of argument is based on the false assumption that defective workmanship can never give rise to an "occurrence" of property damage, and thus, can never be within the initial coverage grant of the CGL policy. This position is contrary to the definitions in the policy, as well as the carefully crafted property damage

exclusions. Despite the fanciful examples set out on Mid-Continent's brief, these exclusions would serve little purpose if the coverage grant did not include the type of damages that are sought against builders such as Lamar.

This same ineffectual argument was made by the insurer and rejected in *American Family Mutual v. American Girl, supra*, 673 N.W.2d at 83-84:

> This interpretation of the subcontractor exception to the business risk exclusion does not 'create coverage' where none existed before, as American Family contends. There is coverage under the insuring agreement's initial coverage grant. Coverage would be excluded by the business risk exclusionary language, except that the subcontractor exception to the business risk exclusion applies, which operates to restore the otherwise excluded coverage.

Mid-Continent's position was also very recently rejected in *J.S.U.B., Inc. v. U. S. Fire Ins. Co.*, 906 So.2d 303 (Fla. App. 2d Dist. 2005), in a defective construction coverage case. There, the insured general contractor constructed a series of homes, and after completion, some homes were damaged when the exterior walls moved or sank as a result of improper compaction of the soil, improper testing of the soil compaction and poor soil or fill material, all attributable to subcontractors. There was structural damage to the home as well as to interior finishes. The insured builder sought coverage under its CGL policy, and the insurer denied the claim. The court held that pursuant to the definition of "occurrence," the term "accident" while not otherwise defined, should include not only accidental events, but also injuries or damages that are neither expected nor intended from the standpoint of the insured. *Id.* at 309. This formulation is in accord with this Court's opinion in *King v. Dallas Fire*.

Like Mid-Continent before this Court, the insurer in *J.S.U.B.* did not contend that the your work exclusion applied, but merely argued that the CGL policy did not apply to the property damage arising out of the subcontractors' work based on the definition of "occurrence." Nevertheless, the court considered the effect of the subcontractor provision in the your work exclusion. After observing that the exclusion did not create coverage, the court stated as follows:

> Similarly, the 'Damage To Your Work' exclusion contains an exception for work performed by a subcontractor on the Builder's behalf. The Insurer does not contend that the exclusion applies; instead, it simply reiterates its view that the policy provides no coverage for the Builder's claims. If the policies provide coverage, the exception to this exclusion would apply because the damage that occurred was the result of the subcontractors' use of poor soil and improper soil compaction and testing. Accordingly, based on our conclusion that the policies provide coverage, this exclusion does not apply because the exception to the exclusion applies.

*Id.* at 310.

Likewise, Mid-Continent's argument that reliance upon the subcontractor provision in the your work exclusion impermissibly creates coverage should be rejected. That coverage exists due to an "occurrence" of property damage as those terms are defined in the policy. Moreover, as in *J.S.U.B.*, this Court should consider the effect of the carefully tailored property damage exclusions, including the your work exclusion and the exception for subcontractor work, in its determination of the coverage that is available to builders under the CGL policies in these circumstances. If this Court does so, it will conclude that there is coverage for this claim.

## III. A CGL POLICY IS NOT CONVERTED INTO A PERFORMANCE BOND BY APPLYING THE POLICY LANGUAGE

Mid-Continent insists that upholding coverage for defective workmanship claims such as the one before this Court will mysteriously, but impermissibly transform the insurance policy into a performance bond. Applying the policy language will do nothing of the kind and this false analogy is a true red herring intended by Mid-Continent to divert the attention of this Court away from the terms of the policy. In order to accept the performance bond argument, this Court would have to forsake the ordinary meaning of the language of the policy before it. This argument, though easier to state than to justify, is divorced from the realities of a modern construction project. Once again, in making it, Mid-Continent demonstrates its misunderstanding of the workings of the construction industry it claims to insure.

### A. An Insurance Policy Spreads The Contractor's Risk While A Bond Financially Guarantees Its Performance

A performance bond is not insurance. The insurance policy is a contract of indemnity, while a surety bond is a guaranty of the performance of the principal's obligations. An insurance policy is issued based on an evaluation of risks and losses that is actuarially linked to premiums. In other words, losses are expected. In contrast, a surety bond is underwritten based on what amounts to a credit evaluation of the particular contractor and its capabilities to perform its contracts, with the expectation that no losses will occur. Sureties usually maintain close relationships with their contractor-principals as well as the contractor's bank, accountants and attorneys. As part of the underwriting of bonds, the surety analyzes the strengths and weaknesses of the contractor and its ability

to perform its obligations. In short, the underwriting process is very similar to the process used by a lender in making a loan. In contrast to insurance, losses are not expected. In addition, the performance bond is not for the protection of the contractor, but rather for the protection of the owner (the "obligee").[10] If the contractor fails to complete its construction contract, the surety may satisfy its obligation to the obligee under the bond by providing additional financing so that the original contractor can complete the work, or by finding another contractor to complete the construction, or finally, by having the obligee complete the job itself, with the surety paying the extra costs.

The performance bond is a three-party instrument between the "obligee", the surety, and the contractor, with the surety retaining a right of indemnity against the contractor as well as other third-party indemnitors, typically the individual owners of a construction company. In the event of a claim, the surety will invoke the indemnity agreement with its principal (the contractor) and the indemnitors to hold it harmless and often to defend it against the claim. Thus, the contractor will, in effect, be required to pay the loss from its own funds when it indemnifies the surety. Of course, an insurance company has no right of indemnity against its insured, although it may seek to recover its losses from third parties through subrogation (or through an increase in premiums). Also, it is the liability insurer that bears the duty to defend claims alleged against its insured

[10] For the sake of simplicity, this argument will use terminology from bonds issued to general contractors in favor of the owner. It also applies to subcontract bonds, issued in favor of a subcontractor to a general contractor.

contractor if those claims arguably are covered under the policy. A surety owes no defense obligation to either its principal or the obligee.

Courts have recognized the profound differences between performance bonds and liability insurance. In *Fidelity & Deposit Co. of Maryland v. Hartford Cas. Ins. Co.*, 189 F.Supp.2d 1212 (D.Kan. 2002), F&D was the surety on the performance bond, and Hartford was the liability insurer for National, a general contractor. After serious construction deficiencies arose at the project, F&D proceeded to complete the construction, which included demolishing and rebuilding portions of the project. F&D incurred substantial costs, and proceeded as assignee of the insured contractor against Hartford. Hartford argued that the damage to the project, caused by National and the negligent workmanship of its subcontractor, Midwest Drywall, was not covered because providing coverage for the damage would transform the insurance policy into a performance bond. The court rejected this argument, explaining that the performance bond and the insurance policy are completely different. The court stated that:

> The court is also not persuaded by Hartford's argument that if the structural damage caused by faulty workmanship constitutes an 'occurrence,' then the CGL and umbrella policies will be transformed into a performance bond. … '[A] performance bond does not 'insure' the contractor[,] [i]t runs to the benefit of the third party owner only.' [Citation omitted.] F&D provided a performance bond on the project that ran to the benefit of the School District, not to National or Midwest Drywall. Since F&D sued National and Midwest Drywall pursuant to an indemnification clause in the performance bond for expenses incurred in finishing the project, the performance bond in no way protected or insured National or Midwest Drywall from liability.

*Id.* at 1218. A similar analysis is found in *Cates Constr., Inc. v. Talbot Partners*, 21 Cal.4th 28, 980 P.2d 407, 412 (Cal. 1999). As to the differences between surety and insurance, the *Cates* court stated as follows:

> A surety is 'one who promises to answer for the debt, default or miscarriage of another, or hypothecates property as security therefor.' . . . A surety bond is a 'written instrument executed by the principal and surety in which the surety agrees to answer for the debt, default or miscarriage of the principal.' . . . In suretyship, the risk of loss remains with the principal, while the surety merely lends its credit so as to guarantee payment or performance in the event that the principal defaults. ... In the absence of default, the surety has no obligation.

In addition to the financial guaranty aspects of the suretyship transaction, the court in *Cates* went on to detail other key differences between insurance policies and performance bonds as follows:

> A construction performance bond is not an insurance policy. Nor is it a contract otherwise marked by elements of adhesion, public interest or fiduciary responsibility, such that an extracontractual remedy is necessitated in the interest of social policy. Obligees have ample power to protect their interests through negotiation, and sureties, for the most part, are deterred from acting unreasonably by the threat of stiff statutory and administrative sanctions and penalties, including license suspension and revocation.

*Id.* 980 P.2d at 427. In other words, a performance bond documents a financial relationship as part of an overall financial transaction. In contrast, an insurance policy is usually an adhesionary risk transfer contract which gives rise to a special relationship and potential tort liability for the insurer under many states' laws. *See also, Commercial Union Assurance Companies v. Gollan*, 394 A.2d 839 (N.H. 1978) (summarily rejecting argument by CGL insurer that payment of claim would convert policy into performance bond); *Lee Builders, Inc. v. Farm Bureau Mut. Ins. Co.*, 104 P.3d 997 (Kan.App. 2005)

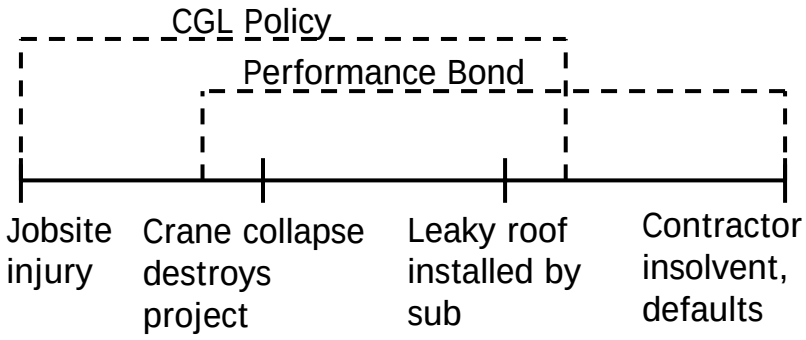
(rejecting performance bond analogy since bond does not insure the contractor, but a third party).

### B. Liability Insurance and Performance Bonds May Converge In Defective Construction Claims

Some claims, particularly claims that involve defective workmanship that cause damage to the project, can trigger ***both*** the CGL policy and the performance bond. In that instance, the CGL policy should respond, particularly in light of the contractor's indemnity obligations to the surety. Upon payment to the owner of a performance bond claim involving defective workmanship, the contractor's rights under its CGL policy are frequently assigned to the surety for pursuit of subrogation. For cases illustrating the scenario of a performance bond surety having paid a claim, and then pursuing coverage for defective workmanship from its principal's CGL insurer, *see, Fidelity & Deposit Co. of Maryland v. Hartford Cas. Ins. Co,* 189 F.Supp.2d 1212 (D.Kan.2002); *Standard Fire Ins. Co. v. Chester-O'Donnelly & Assoc., Inc.,* 972 S.W.2d 1 (Tenn.App. 1998)(upholding recovery by surety from CGL insurer for damage arising out of principal's defective work).

One of the undercurrents running through Mid-Continent's argument is that the scope of "coverage" of a performance bond and CGL policy must be mutually exclusive. While it is true that there are many types of risks and losses that fall within the ambit of a bond and not an insurance policy, and vice vesa, there remains a considerable overlap between the two. This is particularly true, where, as in the case of defective work, a breach of the bonded contract may be involved. In that connection, the following diagram

can be considered:




This diagram illustrates a continuum of job-site risks.[11] Along that continuum, at the left are pure CGL policy losses, i.e., bodily injuries, and moving farthest to the right, a performance default by the contractor, a pure performance bond loss. Superimposed on that continuum is the scope of coverage provided by a CGL policy and a performance bond, signified by the dotted lines. As can be seen, there is an overlap in the middle.

Starting at the left, assume that an accident at the job site seriously injures the employee of a subcontractor to the insured. In the event the insured contractor is sued by that employee, the contractor's CGL policy would respond to this claim. The performance bond is not implicated by the bodily injury. Next, assume a subcontractor's crane collapses, causing damage to major portions of the project. Absent a waiver of

[11] This diagram is included in undersigned counsel's book, PATRICK J. WIELINSKI, DEFECTIVE CONSTRUCTION, SECOND EDITION (2005), at page 289 – 290. Counsel would never be so presumptuous as to cite his own book to a court as authority; however, Mid-Continent has challenged Lamar's reliance upon it at page 45 of its brief. The diagram has been relied upon in numerous presentations to state and national continuing legal education seminars, concentrating both on construction and insurance law. The fact that the undersigned represents mostly insureds in insurance coverage disputes does not prevent the diagram, nor the commentary, from aiding in the understanding of these issues. Mid-Continent apparently deplores it because it tends to "call their bluff" on these issues. INSURANCE FOR DEFECTIVE CONSTRUCTION, SECOND EDITION, is available in the "Legal > Area of Law – By Topic > Treatises & Analytical Materials > International Risk Management Institute (IRMI)" library on Lexis, as well as on the IRMI-Online.com website.

subrogation, the contractor's CGL policy may be required to respond to that loss. At the same time, the collapse and the attendant damage may constitute a breach of the general contractor's bonded contract, falling within the bonded obligation of the contractor, and thus the performance bond. Much the same can be said for a leaky roof installed by the roofing subcontractor on a project. Again, the contractor's CGL policy should respond to claims for property damage, even for the cost of repairing the roof itself based upon the subcontractor provision in the your work exclusion. Likewise, the roofing failure will constitute a breach of the bonded contract, thus implicating the performance bond. Finally, at the far right of the continuum is a classic default by the bonded contractor caused by insolvency. Such a default is a performance bond matter and should not impact liability coverage for the contractor as an insured.Thus, the diagram demonstrates that many claims, particularly defective work claims, may have a potential impact on both the performance bond and the CGL policy. The two seldom can be separated from each other where there is a breach of contract involving the work. In *Kalchthaler v. Keller Constr. Co.*, 591 N.W.2d 169 (Wis.App. 1999), the court recognized this overlap applying the subcontractor provision in Exclusion (l) to uphold coverage for claims against a general contractor for water damage to the interior of new construction caused by faulty window installation by a subcontractor. In the course of doing so, it stated as follows:

> For whatever reason, the [insurance] industry chose to add the new exception to the business risk exclusion in 1986. We may not ignore that language when interpreting case law decided before and after the addition. To do so would render the new language superfluous. [Citation omitted.] …

> We have not made the policy closer to a performance bond for general contractors, the insurance industry has.

*Id.* at 174. Once again, in reaching its conclusion, the court concentrated on the language of the policy before it and not the insurer's overly simple argument that to grant coverage would "turn the CGL policy into a performance bond." For a case reaching a similar conclusion, *see*, *O'Shaughnessy v. Smuckler Corp.*, *supra*.

Mid-Continent gets no mileage out of its "CGL as performance bond" argument. As previously stated, the installation of defective work by a contractor that results in property damage to the project can also involve a default by that contractor under the performance bond. When that occurs, and a surety takes over or finances the completion of the project, it turns its attention to recouping its loss from other parties, including the insured contractor. If the claim involves defective work in breach of the bonded contract and an "occurrence" of property damage that is not subject to exclusion under the CGL policy, particularly the property damage exclusions, the surety may seek recovery as an assignee of the insured contractor, or simply under a theory of equitable subrogation. Ironically, if this case involved a public or a larger project for which the contractor was bonded, it is possible that Mid-Continent would be facing a subrogation claim by the performance bond surety. The irony of such a result is apparently lost on Mid-Continent.

## PRAYER

Amici Curiae ask the Court to answer "yes" to all three questions certified by the Fifth Circuit.

Respectfully submitted,

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I certify that on **February 1, 2006**, a true and correct copy of this brief and its appendix (along with an electronic copy on disk) was served by certified mail, return receipt requested, on the following counsel of record:

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