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Texas Supreme Court: Defective Construction Claims Arising Under Contract Are Covered "Occurrences" Under CGL Policies

On 31 August 2007, the Texas Supreme Court held that a homeowner's claim against a home builder for construction defects equates to an "occurrence" or "accident" under a comprehensive general liability ("CGL") policy. In holding that the insurer had a duty defend against the homeowner's claim of defective construction, the Court found that:

... the CGL policy makes no distinction between tort and contract damages. The insuring agreement does not mention torts, contracts, or economic losses; nor do these terms appear in the definitions of "property damage" or "occurrence." The CGL's insuring agreement simply asks whether "property damage" has been caused by an "occurrence." Therefore, any preconceived notion that a CGL policy is only for tort liability must yield to the policy's actual language.

Lamar Homes, Inc. v. Mid-Continent Cas. Co., No. 05-0832, p. 14 (Tex. August 31, 2007)

The impact of the *Lamar Homes* opinion is not restricted the interpretation of an "accident" or "occurrence" under a CGL policy. The Court went on to hold that Article 542 of the Texas Insurance Code, which contains a penalty provision for late payment of claims, applies to CGL policies. This is a significant development, as Art. 542 has historically been viewed as a statute to motivate only policies involving first party coverage, such as property, life, accident and health policies. The *Lamar Homes* opinion now extends the award of attorney's fees and 18% interest remedies to those insureds that prevail on claims against insurers for violations of Art. 542.



Texas Courts Divided Over the Scope of an “Occurrence” and Article 542

For the last few decades there has been a split in the state appellate and federal courts in Texas concerning whether an “occurrence” includes allegations of defective workmanship arising under a construction contract. In the last three years a schism has also developed between these courts regarding the application of Art. 542 to defense costs under a CGL policy. In *Lamar Homes*, the United States Court of Appeals for the Fifth Circuit certified three questions to the Texas Supreme Court. These questions were:

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?

The Texas Supreme Court answered all three questions in the affirmative.

***Lamar Homes*: Analysis of an “Occurrence”**

The Texas Supreme Court initially determined whether claims of defective construction or faulty workmanship that damages only the work of the insured is an “occurrence.” The insurer had maintained that damages to the work of the insured were economic damages flowing directly from the insured’s breach of contractual obligations and, therefore, were expected and foreseeable.



The Court disagreed with the insurer's position that the failure to perform under a contract is always an intentional act and found that:

... a deliberate act, performed negligently, is an accident if the effect is not the intended or expected result; that is, the result would have been different had the deliberate act been performed correctly.

Id at p. 7 (citing to *Mass. Bonding & Ins. Co. v. Orkin Exterminating Co.*, 416 S.W.2d 396, 400 (Tex. 1967)). In the eyes of the majority of the Court, allegations of faulty workmanship and defective performance clearly fall within the definition of an "accident" under a CGL policy.

There is nothing in the *Lamar Homes* opinion that limits this holding to claims involving residential construction claims. The reasoning of the Texas Supreme Court could arguably extend coverage to claims arising in connection with commercial construction, civil engineering and the fabrication of offshore structures, as well as the manufacturing of various products.

The *Lamar Homes* opinion was rendered in the context of an insurer's defense obligation under a CGL policy. The Court recognized that, under Texas law, a determination of an insurer's duty to indemnify is based not on the claimant's allegations but rather by proof generated in the underlying claim or suit. We anticipate, however, that the Court's interpretation of an "occurrence" will be used by state and federal courts in Texas considering whether an insurer has a duty to indemnify an insured against claims of defective workmanship.

Lamar Homes: Damage to Insured's Work

The Texas Supreme Court found that the standard CGL policy grants the insured broad coverage for property damage that includes damage to the insureds own work resulting from faulty workmanship, as long as the damage amounts to "physical injury" to "tangible property." The Court did recognize that the "business risks" (ISO exclusions j, k, l, m and n) would limit the broad coverage grant of the CGL policy. In this instance, however, the Court held that the "contractor exception" to exclusion l of the policy would preserve the broad coverage afforded by the policy. Obviously, under the *Lamar Homes* opinion, coverage for



damage to an insured's property, an insured's work or an insured's product is limited only by the business risks, or similar, exclusions contained in liability policies.

Lamar Homes: Art. 542 Remedies Apply to Liability Policies

Art. 542 of the Texas Insurance Code requires insurance companies to acknowledge, accept or reject and pay claims within strict time limitations. If an insurer fails to comply with these requirements, the insurer may be liable to the insured for attorney's fees incurred by the insured in pursuing insurance payments, as well as a statutory penalty of 18% interest per annum.

Historically, Art. 542 and its predecessor, Art. 21.55, have been applied to first party policies and not liability policies. In *Lamar Homes*, the Texas Supreme Court found that the statute failed to define the term "first party claim" and extended the definition to include a liability insurer's obligation to pay defense costs. As a result of this ruling, a liability insurer will now be required to pay defense costs within the deadlines set forth in Art. 542. This time requirements will begin to run when the insured provides the insurer with the invoices for the defense fees and costs.

The Court attempts to restrict the *Lamar Homes* opinion to an insurer's obligation to pay defense fees and costs. The Court reasoned that:

Without the defense benefit provided by a liability policy, the insured alone would be responsible for these costs. Unlike the loss incurred in satisfaction of a judgment or settlement, this loss belongs only to the insured and is in no way derivative of any loss suffered by a third party.

It is questionable, whether the Court's restrictive analysis will withstand scrutiny, as an insured's liability to a third party claim would also be borne solely by the insured, in addition to the defense costs, if the insurer did not provide coverage. Additionally, the insured's defense fees and costs are triggered by a claim made by a third party. It is foreseeable that the Court could widen the application of Art. 542 to include a liability insurer's obligation to



provide an unqualified defense and indemnity or, alternatively, a reservation of rights to the insured within the strict deadlines of the statute.

It is apparent that the Texas Supreme Court has increased the exposure of liability insurers to statutory penalties. The real impact of the *Lamar Homes* opinion will become apparent as policyholders increasingly look toward their insurers to pay for claims arising out of the insured's inadequate performance or unsatisfactory work product. It is also foreseeable that business entities pursuing breach of contract claims will be encouraged by the fact that insurance coverage now exists for commercial claims involving defective products or manufacturing.

Due to the significant impact that the *Lamar Homes* opinion will have on the insurance industry, as well as the companies that purchase liability coverage, we anticipate that a motion for rehearing and various amicus curiae briefs will be filed with the Texas Supreme Court.

Should you have any comments or questions concerning the *Lamar Homes* opinion or other coverage matters, please contact:

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