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INSURANCE COVERAGE 101 FOR CONSTRUCTION LAWYERS

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A. Introduction

This paper addresses common insurance coverage issues arising in construction disputes. While Texas law serves as our backdrop, the paper raises issues you are likely to see regardless of the state in which you practice. In most circumstances, a Commercial General Liability Policy ("CGL Policy") is at issue. This paper addresses whether a claim is covered, whether various exclusions from coverage may apply and if any exception exists that brings the claim within the policy's coverage. Reservation of Rights letters ("RoR") and conflicts of interest warrant discussion, as they can often arise in construction defect cases.

B. CGL Policy as a Guide

The CGL Policy can provide coverage for liability claims made against your client/the insured. Before proceeding it is necessary to determine the law of the State which will govern the interpretation of the Policy.

For instance, Article 21.42 of the Texas Insurance Code confirms Texas law will govern the interpretation of an insurance policy when: (1) the insurance proceeds are payable to a Texas citizen or inhabitant; (2) the policy is issued by an insurer doing business in Texas; and (3) the policy is issued in the course of the insurer's business in Texas. *See* Tex. Ins. Art. Ann. §21.42.

When determining whether an insurer has a duty to defend, Texas courts, like those in many other states, follow the eight-corner rule. This involves looking at the four corners of the petition for

alleged facts that could possibly come within the coverage provided by the four corners of the insurance policy. Some states may call it the four-corner rule, but the determination of the defense obligation hinges on the plaintiff's pleading allegations. The duty to defend is broader than, and distinct from, the duty to indemnify. The duty to defend does not depend on the truth or falsity of the allegations; a plaintiff's factual allegations that could potentially support a covered claim are all that is needed to invoke the insurer's duty to defend. See *King v. Dallas Fire Ins. Co.*, 85 S.W.3d 185, 191 (Tex. 2002). If the duty is triggered, the insurer must show the claim falls within an exclusion in the policy in order to avoid the defense obligation.

In contrast, the duty to indemnify is the insurance company's obligation to pay, on behalf of an insured, sums for which the insured is legally obligated to pay because of injury or damage caused to a third party by acts/omissions of the insured. The duty to indemnify is determined by the facts actually established in the underlying suit. *See D.R. Horton-Texas, Ltd. v. Markel International Insurance Company, Ltd*., 300 S.W.3d 740 (Tex. 2009).

a. CGL Coverage Grants

In construction litigation, a third-party claimant typically asserts a claim against a company for property damage or bodily injury. The company's CGL Policy will be specific as to whether that claim is or is not covered within the Policy and states a version of the following:

> a. We will pay those sums that the insured becomes legally obligated to pay as damages because of "bodily injury" or "property damage" to which this insurance applies. We will have the right and duty to defend the insured against any "suit" seeking those damages. However, we will have no duty to defend the insured against any "suit" seeking damage for "bodily injury" or "property damage" to which this insurance does not apply. We may, at our discretion, investigate any "occurrence" and settle any claim or "suit" that may result. But….
>
> b. This insurance applies to "bodily Injury" and "property damage" only if:
> (1) The "bodily injury" or "property damage" is caused by an "occurrence" that takes place in the "coverage territory"; and
> (2) The "bodily injury" or "property damage" occurs during the policy period.

Insurers must defend the entire suit, even if only one of several claims against the insured is potentially covered by the CGL policy. See *Wilshire Ins. Co. v. RJT Constr., LLC*, 581 F.3d 222, 227 (5th Cir. 2009). Insurers may withdraw from the defense once the suit is confined to claims that fall outside coverage. *See Acadia Ins. Co. v. Peerless Ins. Co.*, 679 F. Supp. 2d 229, 237-38 (D. Mass. 2010). Insurers must continue to defend the policyholder during any appeals. *See Iacobelli Const. Co. v. W. Cas. & Sur. Co.*, 343 N.W.2d 517, 521-522 (Mich. App.1983) (the duty to defend includes the costs of prosecuting an appeal).

Some CGL policies give the insurer the right to defend, rather than impose the obligation or duty to defend. If the policy solely gives the insurer the right to defend, the insurer may resist undertaking the defense unless it believes that it can reduce its exposure by providing the defense.

i. <u>Occurrence</u>

Occurrence will be defined in each policy but most often is defined as an accident, including continuous or repeated exposure to substantially the same general harmful conditions. What constitutes an occurrence is most often the subject of property damage claims rather than bodily

injury claims, which arise from a specific event causing personal injuries. Conversely, water damage and water intrusion cases often provide facts that make pinpointing when an occurrence happens difficult. Texas courts have held that the primary issue is whether an 'occurrence' has caused "property damage," not whether the ultimate remedy for that claim lies in contract or in tort. *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 242 S.W.3d 1, 16 (Tex. 2007) (*citing King v. Dallas Fire Ins. Co.*, 85 S.W.3d 185, 191–92 (Tex. 2002)). The CGL Policy defines 'property damage' as meaning: "a. Physical injury to tangible property, including all resulting loss of use of that property. All such loss of use shall be deemed to occur at the time of the physical injury that caused it; or b. Loss of use of tangible property that is not physically injured. All such loss of use shall be deemed to occur at the time of the 'occurrence' that caused it." In fact, the Texas Supreme Court held that "claims for damage caused by an insured's defective performance or faulty workmanship" may constitute an "occurrence" when "property damage" results from the "unexpected, unforeseen or undersigned happening or consequence" of the insured's negligent behavior. See *Id*. at 16.

ii. Property damage

The CGL Policy often also requires that property damage occur during the term of the policy. The Texas Supreme Court has opined that damage occurs at the time of the "actual physical damage" to the property, and not the time of the "negligent conduct" or the "process ... that later results in" the damage. *See Don's Bldg. Supply, Inc. v. OneBeacon Ins. Co.*, 267 S.W.3d 20, 24, 29–30 (Tex. 2008). The definition of "property damage" in CGL policies generally includes both:

- Physical injury to tangible property, including all resulting loss of use of that property.
- Loss of use of tangible property that is not physically injured.

However, most CGL policies do not define the terms physical injury and tangible property. Thus, Courts have adopted varying interpretations of these terms and what constitutes property damage. Courts generally hold that "physical injury" requires actual physical injury to property, such as an alteration in appearance, shape, size, color, or other attributes of the property. *See Fine Paints of Europe, Inc. v. Acadia Ins. Co.*, 2009 WL 819466, at *5 (D. Vt. Mar. 24, 2009)(defective paint that altered the appearance of a home); *See Essex Ins. Co. v. Bloomsouth Flooring Corp.*, 562 F.3d 399, 406 (1st Cir. 2009) (Odor that is permeating or pervasive).

Courts generally interpret the undefined term tangible property in a CGL policy as property capable of being handled, touched, or physically possessed. See *Sec. State Bank of Kansas City v. Aetna Cas. & Sur. Co.*, 825 F. Supp. 944, 947 (D. Kan. 1993) (Real and personal property, including currency, qualify as tangible property).

A loss of use claim occurs when the policyholder's defective property renders a third party's property completely unusable or partially unusable. *See Silgan Containers Corp. v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, 2010 WL 1267127, at *7 (N.D. Cal. Mar. 29, 2010) (Completely unusable - finding coverage when the policyholder's defective circuit boards were inserted into a third party's scanners and rendered them unusable); *See Hartzell Industries, Inc. v. Fed. Ins. Co.*, 168 F. Supp. 2d 789, 795 (S.D. Ohio 2001) (Partially unusable - finding coverage when the policyholder's faulty roof fans prevented the third-party claimant's employees from working in the affected building).

iii. Bodily injury

In respect of injury claims, the CGL Policy requires that bodily injury occur during the term of the policy. Most CGL policies define "bodily injury" as "bodily injury, sickness or disease." Courts interpret bodily injury as encompassing only physical harm, not emotional distress or mental anguish. *See O'Dell v. St. Paul Fire & Marine Ins. Co.*, 478 S.E.2d 418, 420 (Ga. Ct. App. 1996). The date

the bodily injury occurred will determine if a claim for bodily injury falls within the covered policy period.

b. Common exclusions

i. Contractual liability

The Contractual Liability Exclusion excludes coverage for "property damage" or "bodily injury" for which the insured is obligated to pay damages by reason of the assumption of liability in a contract or agreement but expressly states in its exception that this exclusion does not apply to liability assumed in a contract that is an "insured contract" provided the "property damage" or the "bodily injury" occurs subsequent to the execution of said contract.

In order to determine if a contract is an "insured contract," you will need to look at the definitions section of the policy at issue as not all policies are identical in how they define an "insured contract".

ii. Business Risk Exclusions

1. Damage to Property

This exclusion is generally known as the "j" exclusion which excludes from coverage the following: Property damage to your own product; Property damage in your care, custody or control; Property damage to property you own, rent or occupy; and damages incurred by the loss of use, withdrawal or recall of your product. Most policies contain exceptions that apply different to each subsection of the j.(1)-(6) damage to property exclusions. Thus, it is important to investigate the facts of the claim, whether you are defending an insured, coverage counsel for the insured or insurer, or the adjuster handling the file.

2. Damage to Your work

The “Your Work” Exclusion has been interpreted to preclude coverage for liability for repairing or replacing an insured’s own defective work; it does not exclude coverage for damage to other property resulting from the defective work. *See Wilshire Ins. Co. v. RJT Constr., LLC*, 581 F.3d 222, 226 (5th Cir. 2009). The definition of Your Work typically means work or operations performed by you or on your behalf and materials, parts or equipment furnished in connection with such work or operations. The definition also includes warranties or representations made at any time with respect to the fitness, quality, durability, performance or use of Your work. For example, if a contractor hired to install tile flooring in a home improperly installs the flooring materials that results in grout cracking, the damage to the flooring materials will not be covered under the policy. However, if the improper installation of the floor causes damage to work performed by other contractors, that damage may be covered if not excluded by another exclusion or endorsement.

3. Impaired Property Exclusion

Sometimes a defendant's negligent work or product does not cause covered damage. In *U.S. Metals, Inc. v. Liberty Mut. Group, Inc.*, 589 Fed. Appx. 659 (5th Cir. 2014), the Court held that the cost to remove undamaged components to replace a faulty part were not covered property, because the CGL Policy included an exclusion for impaired property. Under Exclusion M, “Damage to Impaired Property or Property not physically injured” (the “impaired property” exclusion), the policy excludes coverage of “Property damage” to “impaired property” or property that has not been physically injured. This reasoning fell in line with the *Lennar* court, which held that the mere incorporation of a defective product is not “property damage” to the defective product itself but does

not discuss whether damage to other integrated components would be considered "property damage." *See Id. Lennar Corp. v. Great Am. Ins. Co.*, 200 S.W.3d 651 (Tex. App.—Houston [14th Dist.] 2006). Conversely, the Seventh Circuit interpreting "physical injury" held that "physical injury" occurred to the other product at the moment of incorporation of the insured's defective product. *Eljer Mfg., Inc. v. Liberty Mut. Ins. Co.*, 972 F.2d 805, 807–14 (7th Cir.1992).

iii. Other Common Exclusions

Most CGL Policies will include exclusions for mold, fungus, earth movement, seepage, leakage and pollution. It is important to look for these exclusions anytime there is a claim for property damage that is caused by water intrusion, foundation issues or flooding. These claims usually occur over time and an exact date of property damage cannot be determined, which could raise issues concerning which policy should respond and provide a defense to an insured.

c. Common endorsements

i. Classification Limitation

An insurer may limit the type of work covered by a policy via a classification limitation. *Essex v. Davis*, 2009 WL 2424088, at *3-4 (N.D. Tex. 2009) (finding no coverage for lawsuit claiming defective installation of a new roof on a synagogue when the insured's classification limitation was for "residential roofing" because a synagogue was not a residence). In *Bluewater Builders, Inc. v. United Specialty Ins. Co.*, No. 13-60396-CIV, 2013 WL 5670957 (S.D.Fla. 2013) a subcontractor working for the insured removed drywall on the eleventh floor of a building, broke a sprinkler head and caused water damage to the tenth and eleventh floors. The insurance policy at issue contained a Classification Limitation Endorsement providing that coverage under the Policy was "strictly limited to the classification (s) and code(s) listed on the policy Declarations page...No coverage is provided for any classification(s) and code(s) not specifically listed on the Declarations page of this policy."

ii. Additional insured

Coverage issues often arise when a party claims insurance coverage from another party. From the insurer's perspective, unless the policy includes an "additional insured" endorsement, the insurer can disclaim coverage. If an additional insured has been included in the endorsement, expressly or on a blanket basis, then the Policy may also afford coverage to that entity. However, the language of the policy will apply to the additional insured in the same way that it applies to the named insured. Additionally, it is important to carefully read the language of the additional insured endorsement. If the named insured is required by a separate contract to name another entity as an additional insured, the language of the policy still controls whether the additional insured's claim is covered. If the named insured is not in compliance with the contract requiring the other party to be named as an additional insured, the named insured may face a separate claim for breach of contract.

C. What is Extrinsic Evidence and Can I use it?

The eight-corner rule requires that the allegations in the petition must be compared to the provisions in the insurance policy to determine if a duty to defend exists. The critical component of a duty to defend analysis requires the court to review the underlying pleadings and "focus on the factual allegations that show the origin of the damages rather than on the legal theories alleged." *Nat'l Union Fire Ins. Co. of Pittsburgh, Pa. v. Merchants Fast Motor Lines, Inc.*, 939 S.W.2d 139, 141 (Tex. 1997).

Faced with this problem in the construction litigation context, where many third party claims, cross, and counter actions arise, courts have turned to related third-party petitions, counter or cross claims, all within the same lawsuit, to determine if a duty to defend exists. *See Evanston Ins. Co. v. Kinsale Ins. Co.*, 7:17-CV-327, 2018 WL 4103031, at *11 (S.D. Tex. July 12, 2018) (finding it necessary to turn to a counterclaim in the same lawsuit "to understand whether the allegations in the VCC Crossclaim state a claim under the Policies" to complete the duty to defend analysis); *E & R Rubalcava Const., Inc. v. Burlington Ins. Co.*, 148 F. Supp. 2d 746, 750 (N.D. Tex. 2001), supplemented (Apr. 18, 2001) ("determining whether Burlington has a duty to defend Rubalcava in the underlying lawsuits, the Court will look to the third-party claims and to the plaintiffs' pleadings.").

Courts have applied the same reasoning when the target petition, subject to the eight corners analysis, incorporates a related petition by reference. *See Employers Mut. Cas. Co. v. N. Ins. Co.*, CIV.A. 308-CV-1498-G, 2010 WL 850243, at *4 (N.D. Tex. Mar. 11, 2010); *Burlington Ins. Co.*, 148 F. Supp. at 750 (turning to plaintiff's original petition which was incorporated by reference in the target third party petition).

In *GuideOne*, the Texas Supreme Court determined that an insurer could not use extrinsic evidence to absolve it from having to defend an underlying suit. *GuideOne Elite Ins. Co. v. Fielder Rd. Baptist Church*, 197 S.W.3d 305, 310 – 311 (Tex. 2006). The *GuideOne* court decided that use of extrinsic evidence was improper. *Id*. In arguing for the exception, amicus parties argued that ignoring the truth or falsity of the underlying suit's allegations would invite fraudulent and "even collusive pleadings." *Id*. Interestingly, some states impose an affirmative obligation on the insurer to investigate a claim and even charge the insurer with utilizing information and extrinsic evidence it *should* discover when evaluating its defense obligations.

GuideOne aside, the Texas Supreme Court, even after several opportunities, has not squarely adopted an extrinsic evidence exception. On the other hand, several Texas intermediate courts of appeal, and the United States Court of Appeals for the Fifth Circuit, have reached the conclusion that extrinsic evidence, as an exception to the eight corners rule, carries the possibility of changing a duty to defend analysis, in favor of the insurer.

The exception would allow extrinsic evidence when "it is initially impossible to discern whether coverage is potentially implicated and when the extrinsic evidence goes solely to a fundamental issue of coverage which does not overlap with the merits of or engage the truth or falsity of any facts alleged in the underlying case." *Northfield Ins. Co. v. Loving Home Care, Inc.*, 363 F.3d 523, 531 (5th Cir. 2004).

Recently, the Texas Supreme Court commented on the so-called "*Northfield* exception," but again, has yet to rule on its validity in law. *See Richards v. State Farm Lloyds*, 597 S.W.3d 492, 497 (Tex. 2020). Indeed, the Texas Supreme Court has acknowledged the exception's "widespread use" by the Fifth Circuit and several Texas intermediate courts of appeal. *Id.* 496 - 497. Despite some cases, Texas has yet to expressly adopt this exception as Texas law.

Another exception to the eight-corners rule that has developed involves the use of extrinsic evidence in determining if an insurer owes a duty to defend exists when there is conclusive evidence that groundless, false or fraudulent claims against the insured have been manipulated by the insured's own hands. *Loya Ins. Co. v. Avalos*, 610 S.W.3d 878 (Tex. 2020), reh'g denied (Oct. 2, 2020). The Court in *Avalos* held that the "eight-corners rule does not bar a court, in determining a liability insurer's duty to defend, from considering extrinsic evidence regarding whether an insured and a third party suing the insured colluded to make false representations of fact in that suit for the purpose

of securing a defense and coverage where they would not otherwise exist." *Id.* The may be few instances where an insurer can invoke these exceptions; however, they are worth considering if and when the pleading allegations are vague or questionable based on other facts and information discovered during the investigation.

D. When to issue ROR?

The purpose of a reservation of rights is to protect both the liability insurer and the insured by allowing an insurer that is uncertain of its obligations under the policy to undertake a defense while reserving its rights to ultimately deny coverage following its investigation. *Am. Safety Indem. Co. v. Sto Corp.*, 342 Ga. App. 263, 802 S.E.2d 488 (2017).

E. Insured's Rights when ROR issues

When a defense is provided under a reservation of rights, an insured may reject the insurer's hiring of defense counsel due to the defense being conditional or the existence of a disqualifying conflict. *See N. County Mut. Ins. Co. v. Davalos*, 140 S.W.3d 685, 689 (Tex. 2004). In *Davalos*, the Supreme Court stated that a reservation of rights letter creates a potential conflict of interest, and that "when the facts to be adjudicated in the liability lawsuit are the same facts upon which coverage depends, the conflict of interest will prevent the insurer from conducting the defense." *See N. County Mut. Ins. Co. v. Davalos*, 140 S.W.3d 685, 689 (Tex. 2004). In contrast, in *Tilley* the Court discussed how the waiver principles are applied stringently to uphold the prohibition against conflicts of interest between the insurer and the insured which could potentially affect legal representation in order to reinforce the role of the lawyer as the loyal advocate of the client's interest. *See Employers Casualty Co. v. Tilley*, 496 S.W.2d 552 (Tx.1973);

If an insured chooses to reject the defense counsel retained by the insurer, another attorney can be hired but at the expense of the insured. In *Graper v. Mid-Continent Cas. Co.*, 756 F.3d 388 (5th Cir. 2014), the court found that the mere assertion of a reservation of rights by the insurer did not require the appointment of independent counsel. The court found that the insureds had unreasonably refused the insurer's offer of a reservation of rights defense when it concluded that there was no disqualifying conflict of interest. As a result, the insureds were obligated to pay their own independent counsel for the defense costs that were incurred.

F. Conclusion

Whether you are involved in a construction litigation as an adjuster, defense, coverage or independent counsel, having an understanding of the commonly encountered issues is vital to you and the party you represent. Being cognizant of coverage issues can provide you an advantage in litigation, mediation and trial regardless of which side of the claim you may find yourself.