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INSURANCE LAW

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I. EXTRA-CONTRACTUAL LIABILITY

A. ARTICLE 21.55¹

AN ongoing issue of debate in Texas is whether Article 21.55 of the Texas Insurance Code applies to an insured's claim for a defense under a liability policy. While several federal district courts in Texas have previously concluded that an insured's demand for a defense is a first-party claim that is subject to Article 21.55, three state courts of appeals issued opinions during this Survey period rejecting the application of Article 21.55 to the duty to defend.

The Fort Worth Court of Appeals explained that Article 21.55 applies to “‘a first party claim . . . that *must be paid by the insurer directly to the insured or beneficiary.*’”² A first-party claim is one in which the insured seeks recovery for its own loss; conversely, a third-party claim requires the insurer to perform its duty to indemnify not directly to the insured, but rather, on the insured's behalf, to a third-party claimant injured by the insured's conduct.³ Emphasizing that the duty to defend arises only in connection with a third-party claim, the court of appeals explained that the insured's claim did not involve damage to its own property and did not seek recovery for its own personal injuries, but instead only sought reimbursement of the costs it incurred in defending a third party suit brought against it.⁴ The court of appeals further noted that the Dallas Court of Appeals had previously concluded, based on the plain language of Article 21.55, that any attempt to apply the statute's structure to a claim for a defense is unworkable and clearly unintended by the

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1. TEX. INS. CODE ANN. art. 21.55 (VERNON 1991). Effective April 1, 2005, Article 21.55 was repealed and recodified, without any substantive change, as Subchapter B of Chapter 542 of the Texas Insurance Code, entitled “Prompt Payment of Claims.” TEX. INS. CODE ANN. §§ 542.051–.061 (VERNON 2006).

2. *Ulico Cas. Co. v. Allied Pilots Ass'n*, 187 S.W.3d 91, 106 (Tex. App.—Fort Worth 2005, pet. granted) (emphasis in original) (quoting TEX. INS. CODE ANN. art. 21.55 § 1(3)).

3. *Id.*

4. *Id.*

legislature.⁵

Stating that it found this reasoning persuasive, the Fort Worth Court of Appeals held that Article 21.55 does not apply to claims for reimbursement of defense costs incurred in defending a third-party claim.⁶ In reaching this conclusion, the court of appeals recognized that it was holding contrary to decisions of several federal courts construing Texas law, but stated that such decisions did not analyze the issue with the same amount of detail as the Dallas Court of Appeals; instead, such decisions relied on prior decisions without considering the persuasiveness of those authorities on this issue.⁷ The Houston and San Antonio Courts of Appeals have followed the decisions of their sister courts and also declined to apply Article 21.55 to the duty to defend.⁸

In contrast to the state appellate courts, the federal district courts in Texas have continued to apply Article 21.55 to claims for defense costs. Indeed, the United States District Court for the Southern District of Texas stated that applicable federal and Texas state cases “generally classify an insurer’s duty to defend as a first-party claim,” and “[t]his ‘majority view’ holds that, although typically part of a liability policy that would be considered ‘third-party,’ the duty to defend is a form of first-party insurance.”⁹ The district court explained that in third-party insurance claims, the interests of the insured and insurer are typically aligned against a third party and that when a claim arises that concerns the relationship between the insurer and the insured, that claim can become a first-party claim.¹⁰ Although the policy at issue disavowed the insurer of any traditional duty to defend, it did obligate the insurer to advance, on behalf of the insured, covered defense costs that the insured incurred in connection with a claim made against it. The district court found that the claim for these costs concerned only the relationship between the insured and the insurer, and no third party. Rather, the insured suffered a direct loss in the amount of its defense costs, and the insured sought recovery for amounts that must be paid by the insurer directly to the insured, as opposed to any loss suffered by a third party.¹¹ For these reasons, the district court concluded that the insured’s claim for reimbursement of its defense costs constituted a first-party claim and, therefore, was a covered

5. *Id.* at 106–07 (citing *TIG Ins. Co. v. Dallas Basketball, Ltd.*, 129 S.W.3d 232, 239 (Tex. App.—Dallas 2004, pet. denied)); *see also* *Summit Custom Homes, Inc. v. Great Am. Lloyds Ins. Co.*, 202 S.W.3d 823, 833 (Tex. App.—Dallas 2006, pet. filed) (following its holding in *Dallas Basketball* and concluding that Article 21.55 is not applicable to an insured’s defense claim).

6. *Id.* at 107.

7. *Id.* at 107–08.

8. *Pine Oak Builders, Inc. v. Great Am. Lloyds Ins. Co.*, No. 14-05-00487-CV, 2006 WL 1892669, at *12–13 (Tex. App.—Houston [14th Dist.] July 6, 2006, no pet.); *Serv. Lloyd’s Ins. Co. v. J.C. Wink, Inc.*, 182 S.W.3d 19, 30–33 (Tex. App.—San Antonio 2005, pet. filed).

9. *HCC Employer Servs., Inc. v. Westchester County Surplus Lines Ins. Co.*, No. H-05-1275, 2006 U.S. Dist. LEXIS 36391, at *27 (S.D. Tex. June 5, 2006).

10. *Id.* at *27–28.

11. *Id.* at *28–29.

claim under Article 21.55.¹²

These decisions are essentially irreconcilable. Thus, there exists a split in authority between the state appellate courts and the federal district courts as to whether Article 21.55 applies to a claim for defense costs. Recognizing this split, the Fifth Circuit certified the following issue to the Texas Supreme Court: “[D]oes Article 21.55 of the Texas Insurance Code apply to a CGL insurer’s breach of the duty to defend?”¹³ While the supreme court has accepted this case and heard oral argument, it will most likely address the question only if it first determines that the insurer at issue breached the duty to defend. Thus, there is a chance that this issue will remain unresolved and the conflict between federal and state courts will continue.

Further, in what appears to be the first case to do so, the District Court for the Southern District of Texas’ opinion in *HCC Employer Services, Inc.* went a step beyond prior federal district court opinions by applying Article 21.55 to the duty to defend as well as to the duty to indemnify in the context of a third-party liability claim.¹⁴ Without citing any additional authority, the district court relied on its discussion with respect to the insured’s claim for defense costs and decided that a “similar analysis” could be applied to the insured’s claim for reimbursement of the amount of an arbitration award it paid to settle a lawsuit brought against it by a third party.¹⁵ The district court determined that the insured suffered a direct loss in the amount of the award and that the insured’s claim against the insurer simply sought recovery for that loss and involved amounts that must be paid by the insurer directly to the insured. For these reasons, the district court concluded that this claim for indemnification also constituted a claim covered under Article 21.55.¹⁶

B. ARTICLE 21.21¹⁷

In *Travelers Personal Security Insurance Co. v. McClelland*,¹⁸ the Houston Court of Appeals for the First District reviewed the trial court’s grant of the insurer’s motion for judgment notwithstanding the verdict, which overturned the jury’s imposition of extra-contractual damages for violation of Article 21.21. While acknowledging that the issue before it was the legal sufficiency of the evidence to show a statutory violation, the court of appeals apparently reviewed the evidence under the common-law-bad-faith standard. Specifically, the court of appeals enunciated the

12. *Id.* at *29.

13. *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 428 F.3d 193, 201 (5th Cir. 2005).

14. *HCC Employer Servs., Inc.*, 2006 U.S. Dist. LEXIS 36391, at *29–30.

15. *Id.* at *29.

16. *Id.* at *29–30.

17. TEX. INS. CODE ANN. art. 21.21 (VERNON 1991). Effective April 1, 2005, Article 21.21 was repealed and recodified, without any substantive change, as Chapter 541 of the Texas Insurance Code, entitled “Unfair Methods of Competition and Unfair or Deceptive Acts or Practices.” TEX. INS. CODE ANN. § 541.001 (VERNON 2006).

18. 189 S.W.3d 846 (Tex. App.—Houston [1st Dist.] 2006, no pet.).

governing standard as: "Under article 21.21 of the Insurance Code, an insurer violates its duty of good faith and fair dealing by denying or delaying payment of a claim when the insurer knew or should have known that it was reasonably clear that the claim was covered."¹⁹ Additionally, the court of appeals based its analysis on *State Farm Lloyds v. Nicolau*,²⁰ the "touchstone case for bad-faith insurance claims," which instructs that evidence showing only a bona-fide coverage dispute, standing alone, does not show bad faith, but that an insurer cannot shield itself from bad-faith liability by investigating a claim in a manner calculated to construct a pretextual basis for denying a claim.²¹

Reviewing the evidence under this standard, the court of appeals emphasized that this case presented "a close call."²² The homeowners' policy at issue excluded coverage for foundation damage due to "natural causes," but an exception to the exclusion covered the resulting damage from foundation movement due to plumbing leaks.²³ The insurer denied the insureds' claim for structural damage to the house from foundation movement based on a report from its engineering expert, which found that the damage was not due to the plumbing leak. Conversely, while conceding that natural causes were part of the problem, the insureds' expert determined that the plumbing leak triggered the movement that caused the damage to the house.²⁴ As in *Nicolau*, the evidence showed that the insurer's engineer worked almost exclusively for insurance companies, knew that plumbing leaks were covered under the policy, and found no connection between plumbing leaks and foundation problems eighty-five to ninety percent of the time.²⁵

The court of appeals explained that although this evidence allowed for the "logical inference" that the insurer hired this particular engineering firm because it consistently found no connection between plumbing leaks and foundation damage, a finding of bad faith under *Nicolau* requires evidence of behavior more egregious than merely hiring a firm whose reports generally feature an outcome favored by its recipient.²⁶ Further, a simple disagreement among experts about whether the cause of the loss was one covered by the policy will not establish bad faith; rather, the insured must prove that the insurer had no reasonable basis for denying or delaying payment and that the insurer knew or should have known that fact.²⁷ Applying these principles, the court of appeals determined that the evidence marshaled by the insureds only showed the insurer's "proclivity to hire an expert of its own preference," and a "simple disa-

19. *Id.* at 852.

20. *State Farm Lloyds v. Nicolau*, 951 S.W.2d 444 (Tex. 1997).

21. *McClelland*, 189 S.W.3d at 852 (citing *Nicolau*, 951 S.W.2d at 448).

22. *Id.* at 853.

23. *Id.* at 848.

24. *Id.* at 848-49.

25. *Id.* at 853.

26. *Id.* at 853-54.

27. *Id.* at 854.

greement among experts.”²⁸ Accordingly, the court of appeals concluded that the evidence did not support a judgment for bad faith and, therefore, was legally insufficient to support the jury’s finding of extra-contractual damages.²⁹

II. CONTRACTUAL LIABILITY

A. THE DUTY TO DEFEND

1. *Whether There Is an Exception to the “Eight-Corners” Rule That Permits Consideration of Extrinsic Evidence in Determining the Duty to Defend*

- a. The Texas Supreme Court Noted That Other Courts Recognize a Narrow Exception but Declined To Do So under the Facts of the Case Before It

An ongoing issue of debate in Texas has been whether any exception to the “eight-corners,” or “complaint-allegation” rule, exists that would permit the consideration of extrinsic evidence in determining an insurer’s duty to defend. The Texas Supreme Court finally provided some guidance on this issue in *GuideOne Elite Insurance Co. v. Fielder Road Baptist Church*.³⁰ The claimant filed a sexual misconduct lawsuit against the insured church and its minister, alleging in her pleadings that, at all material times from 1992 to 1994, the minister was employed by and was under the church’s direct supervision and control when he sexually exploited and abused her. The church demanded defense and indemnity from the insurer, which agreed to defend under a reservation of rights.³¹ The insurer filed a declaratory judgment action seeking a declaration that it had no duty to defend or indemnify the church. Through discovery during the coverage action, the insured advised the insurer that the minister had ceased working for it on December 15, 1992, before the insurer’s policy took effect. The trial court rendered summary judgment in favor of the insurer, declaring that it had no duty to defend. However, the court of appeals reversed the judgment, concluding that the trial court had erred in considering extrinsic evidence to defeat the duty to defend.³²

The Texas Supreme Court explained that Texas follows the eight-corners or complaint-allegation rule, which holds that only two documents are ordinarily relevant to determining the insurer’s duty to defend: the policy and the pleading of the third-party claimant. Under this rule, the pleadings are considered in light of the policy provisions without regard to the truth or falsity of those allegations; facts outside the pleadings—even those easily ascertained—are ordinarily not material to the determination; and allegations against the insured are liberally construed in favor

28. *Id.*

29. *Id.*

30. 197 S.W.3d 305, 306–07 (Tex. 2006).

31. *Id.* at 307.

32. *Id.*

of coverage.³³ The supreme court noted that, although it has never expressly recognized an exception to the eight-corners rule, other courts have drawn a very narrow exception, and have permitted the use of extrinsic evidence only when relevant to an independent and discrete coverage issue that does not address the merits of the underlying third-party claim.³⁴

Because the extrinsic evidence relied on by the insurer was relevant to both coverage and the merits, and thus did not fit into the previously recognized exception to the eight-corners rule, the insurer asserted that the supreme court should broaden the exception to include this type of “mixed” or “overlapping” extrinsic evidence.³⁵ Emphasizing that very little support exists for this position and that the Fifth Circuit previously rejected a similar use of overlapping facts for this purpose, the supreme court “likewise reject[ed] the use of overlapping evidence as an exception to the eight-corners rule because it poses a significant risk of undermining the insured’s ability to defend itself in the underlying litigation.”³⁶

The supreme court further explained that those courts that have recognized an exception to the eight-corners rule have done so under limited circumstances involving pure coverage questions, and that if it were to recognize the exception urged by the insurer, it “would by necessity conflate the insurer’s defense and indemnity duties without regard for the policy’s express terms.”³⁷ Specifically, the policy obligated the insurer to indemnify the church in the event of a meritorious claim for sexual misconduct, but, with respect to the duty to defend, the policy required the insurer to “‘defend any suit brought against [the insured] seeking damages, even if the allegations of the suit are groundless, false or fraudulent’”³⁸ Thus, the policy defined the duty to defend more broadly than the duty to indemnify, and the former is the circumstance assumed to exist under the eight-corners rule. A claimant’s factual allegations that potentially support a covered claim is all that is needed to invoke the insurer’s duty to defend; conversely, the facts actually established in the underlying suit control the duty to indemnify. Applying these principles, the supreme court decided that the claimant’s allegations—that the minister assaulted her during the policy period and was a minister at the church at the time—were sufficient to trigger the insurer’s duty to defend.³⁹

In reaching this decision, the supreme court rejected the insurer’s contention that it should not have to defend because the minister was not in fact an employee during the policy period; the supreme court explained that the duty to defend does not turn on the truth or falsity of the claim-

33. *Id.* at 308.

34. *Id.*

35. *Id.* at 309.

36. *Id.*

37. *Id.* at 310.

38. *Id.*

39. *Id.* at 310–11.

ant's allegations, and where the insurer knows the allegations to be untrue, it must establish such facts in defense of its insured rather than as an adversary in a declaratory judgment action.⁴⁰ The supreme court also rejected an amicus's suggestion that it should adopt a "true-facts exception" to the eight-corners rule to prevent the rule's recurring use as a tool for fraud, noting that the record did "not suggest collusion or the existence of a pervasive problem in Texas with fraudulent allegations designed solely to create a duty to defend."⁴¹ Accordingly, the supreme court concluded that application of the eight-corners rule in this case conformed with the parties' contract and that "the circumstances of this case present[ed] no basis for an exception to that rule."⁴²

b. After *GuideOne*, Other Courts Have Continued to Recognize That Extrinsic Evidence May Be Considered in Certain Circumstances

Although the Texas Supreme Court declined to apply an exception to the eight-corners rule under the circumstances in *GuideOne*, subsequent decisions from other courts have interpreted this decision as leaving open the possibility of such an exception. For example, in *B. Hall Contracting Inc. v. Evanston Insurance Co.*,⁴³ the United States District Court for the Northern District of Texas explained that extrinsic evidence establishing non-coverage, specifically, facts establishing the applicability of a "Roofing Endorsement exclusion," did not contradict any allegations in the underlying state court pleadings, but instead was "perfectly consistent" with allegations made in the state court pleadings.⁴⁴

The insurer in *B. Hall Contracting* was not taking the position that any allegation made in the state court pleadings was false or fraudulent; rather, the insurer accepted the allegations of the state court pleadings as true but pointed out that there was no insurance coverage for the claims asserted by those allegations. The district court determined that the instant situation was quite different from that in *GuideOne*, where the fact on which the insurer relied to avoid coverage disputed a pleaded fact that was an element of the underlying damage suit, and where the issue was not one of coverage, but rather one of the merit of the underlying allegations.⁴⁵ The district court emphasized that the potential merit of the damage suit was a separate and distinct issue from the issue of whether the damages alleged in that suit were covered under the policy. While, coincidentally, some of the same facts might have been relevant to those separate issues, none of the facts relied on by the insurer to defeat insurance coverage would contradict, much less defeat, the claims asserted in

40. *Id.* at 311.

41. *Id.*

42. *Id.*

43. 447 F. Supp. 2d 634 (N.D. Tex. 2006).

44. *Id.* at 646 (quoting *GuideOne*, 197 S.W.3d at 305).

45. *Id.* at 647.

the underlying suit.⁴⁶ Accordingly, the district court concluded that the extrinsic evidence establishing non-coverage was relevant to an independent and discrete coverage issue not touching on the merits of the underlying claims, and, therefore, the exception to the eight-corners rule applied.⁴⁷

The United States District Court for the Southern District of Texas similarly interpreted *GuideOne* as permitting a narrow exception to the eight-corners rule in certain circumstances where the extrinsic evidence relates solely to the coverage issue:

Although the Texas Supreme Court explicitly rejected the use of extrinsic evidence that was relevant both to coverage and to the merits of the underlying action, it did not rule on the validity of a more narrow exception that would allow extrinsic evidence solely on the issue of coverage. In fact, the language of the opinion hints that the court views the more narrow exception *favorably*. For example, the court specifically acknowledged that other courts recognized a narrow exception for extrinsic evidence that is relevant to the discrete issue of coverage and noted that the Fifth Circuit had opined that, were any exception to be recognized by the Texas high court, it would likely be such a narrow exception.⁴⁸

The district court also noted that the *GuideOne* court distinguished, but did not overrule, the *International Services Insurance Co. v. Boll*⁴⁹ decision in which the Houston Court of Appeals relied on an external stipulation to find that the underlying allegations were not covered.⁵⁰ The district court determined that the case before it was similar to *Boll* in that “external undisputed information readily clarifies vague allegations in the pleadings.”⁵¹ Specifically, although the third-party petition filed by the defendant against the insured made no mention of the time period during which the property damage occurred, the petitions filed by the plaintiffs against the defendant did allege the pertinent dates. Because the relief that the defendant sought from the insured was based entirely on the allegations of the plaintiffs in the same underlying lawsuit, the district court concluded that it could rely on extrinsic evidence in the form of the plaintiffs’ petitions “to fill in the temporal details” that were necessary to

46. *Id.*

47. *Id.*

48. *Bayou Bend Homes, Inc. v. Scottsdale Ins. Co.*, No. H-05-1544, 2006 WL 2037564, at *5 (S.D. Tex. July 18, 2006) (emphasis added) (citations and footnote omitted). The district court also noted that a state intermediate appellate court had taken a similar approach. *Id.* at *5 n.27 (citing *Pine Oak Builders*, 2006 WL 1892669, at *5–6 (rejecting a more permissive rule that would allow the consideration of extrinsic evidence whenever the evidence does not contradict the pleadings, but suggesting, without explicitly stating, that it would allow extrinsic evidence to establish fundamental coverage facts)).

49. *Int’l Servs. Ins. Co. v. Boll*, 392 S.W.2d 158 (Tex. Civ. App.—Houston 1965, writ ref’d n.r.e.).

50. *Bayou Bend Homes*, 2006 WL 2037564, at *5 (referencing *id.*).

51. *Id.* at *6.

determine the coverage issue.⁵²

2. *The Insurer's Right to Control the Defense*

The article for the last Survey included a decision by the Fifth Circuit allowing an insurer to intervene to challenge on appeal an adverse liability judgment entered against its insured.⁵³ The Fifth Circuit subsequently issued a second opinion in this case upon its denial of the claimants' petition for rehearing.⁵⁴ The Fifth Circuit explained that, under Federal Rule of Civil Procedure 24(a), a "direct" interest is required to intervene as of right.⁵⁵ By definition, an interest is not direct when it is contingent on the outcome of a subsequent lawsuit. When an insurer defends a suit against its insured under a full reservation of its right to contest coverage later, the insurer's interest in the liability lawsuit is contingent upon the outcome of the coverage lawsuit. The Fifth Circuit determined that this interest, without more, is insufficient for intervention.⁵⁶ This case, however, presented a different situation. The insurer initially defended the insured under a full reservation of rights and denied coverage for a particular claim based on a line of cases from the Fifth Circuit. After the Texas Supreme Court issued a decision rejecting the Fifth Circuit's approach, the insurer defended from that point forward under a limited reservation of rights, accepting coverage for any negligent conduct while denying coverage for any intentional conduct. The Fifth Circuit concluded that once the insurer accepted coverage over any negligence liability on the part of its insured, it had a direct interest in the liability lawsuit and, therefore, a sufficient interest to intervene.⁵⁷

B. CONTRACTUAL LIABILITY BASED ON WAIVER OR ESTOPPEL

In *Ulico Casualty Co. v. Allied Pilots Ass'n*,⁵⁸ the Fort Worth Court of Appeals addressed the circumstances in which an insurer may waive or be estopped from asserting coverage defenses.⁵⁹ In this case, the insured sought coverage for an underlying suit against it, and the insurer agreed to cover the insured's defense costs pursuant to a reservation of rights. Approximately a year and a half later, the insurer realized that the insured had not reported the claim during the policy period as required by

52. *Id.*; see also *J.C. Wink, Inc.*, 182 S.W.3d at 1, 28–29 (rejecting the insurer's argument that it had no duty to defend because the underlying petition did not allege that the insured harmed the plaintiff during the policy period, and determining that although the petition did not give specific dates for the disputed sales, it did allege that all sales occurred between a certain date and the date when suit was filed, a period that encompassed the policy period, and, therefore, that the petition potentially alleged damages from conduct occurring during the policy period).

53. *Ross v. Marshall*, 426 F.3d 745, 748 (5th Cir. 2005), *reh'g denied*, 456 F.3d 442, 442 (5th Cir. 2006).

54. *Ross v. Marshall*, 456 F.3d 442 (5th Cir. 2005), *cert. denied* 127 S. Ct. 1125 (2007).

55. *Id.* at 443 (citing FED. R. CIV. P. 24(a)).

56. *Id.*

57. *Id.* at 443–44.

58. 187 S.W.3d 91, 98 (Tex. App.—Fort Worth 2005, *pet. granted*).

59. *Id.* at 98–102.

the policy, at which point the insurer brought a declaratory judgment action against the insured, seeking a declaration that it did not owe the defense costs. The insured counterclaimed for breach of contract. The trial court entered judgment in favor of the insured under a waiver and estoppel theory of liability.⁶⁰

The court of appeals explained that, while estoppel generally cannot be used to create coverage when none exists under the policy, the *Wilkinson* exception to this general rule provides, "an insurer undertaking or continuing defense of a claim while having knowledge of facts indicating the claim is not covered under its policy, without an effective reservation of rights, may waive or be estopped from asserting all policy defenses, including the defense of noncoverage."⁶¹ This exception is based on the actual or potential conflict of interest that arises when an insurer assumes the defense and represents the insured in an underlying suit and simultaneously formulates its defense against the insured for noncoverage.⁶² The court of appeals emphasized that although neither it nor the Texas Supreme Court had ever addressed the *Wilkinson* exception, the exception had been employed by state appellate courts and federal courts in the Fifth Circuit, applying Texas law, for over twenty years and was "well-established."⁶³

Reviewing the sufficiency of the evidence in the context of the *Wilkinson* exception, the court of appeals first addressed the insurer's contention that the exception requires the insurer to have actual control of the defense. Rejecting such a narrow interpretation, the court of appeals emphasized that *Wilkinson* and other cases applying the exception do not require the presence of an actual conflict between the insurer and insured, but, rather, they apply the exception based on the *potential* for such a conflict.⁶⁴ The court of appeals explained the fact that the underlying suit was resolved favorably for the insured on summary judgment did not alleviate the *potential* for conflict between the insurer and the insured, and the insurer should not get a "free pass" simply because the insured successfully defended the suit.⁶⁵ Although the insurer did not control the insured's counsel or its defense, the insurer did agree to pay defense costs and also attempted to assert a provision in the policy prohibiting the insured from incurring defense costs without the insurer's prior approval. Further, had the insured not prevailed in the suit, the insurer, knowing that it was investigating the coverage issue, could have refused to approve fees and costs related to discovery, the procurement of experts, or other matters related to the defense. Under these facts, the court of appeals determined that the insurer did undertake or assume the

60. *Id.* at 95-97.

61. *Id.* at 98 (citing *Farmers Tex. County Mut. Ins. Co. v. Wilkinson*, 601 S.W.2d 520, 521-22 (Tex. Civ. App.—Austin 1980, writ ref'd n.r.e.)).

62. *Id.*

63. *Id.* at 99.

64. *Id.* at 100.

65. *Id.*

defense of the suit against the insured.⁶⁶

The court of appeals next addressed the *Wilkinson* exception's requirement of a showing that the insured was prejudiced by the insurer's conduct. The court of appeals found that even though the insured was able to successfully defend itself with the counsel of its choice, it was nevertheless harmed by the insurer's representation that it would provide coverage for defense costs.⁶⁷ First, the insured was denied the opportunity to negotiate a satisfactory premium for an extension of the policy's expiration date. Second, instead of immediately informing the insured about the coverage mistake, the insurer waited six months to take any action. When it finally did take action, it initiated a declaratory judgment action against the insured without informing the insured that it was withdrawing its coverage of defense costs, and thereby forcing the insured to incur additional fees to defend the coverage action. Based on these facts, the court of appeals determined that there was more than a mere scintilla of evidence that the insured was prejudiced by the insurer's actions.⁶⁸ Accordingly, the court concluded that the *Wilkinson* exception applied and that there was legally sufficient evidence to support the jury's findings on waiver and estoppel.⁶⁹

C. NOTICE AND COOPERATION PROVISIONS

Several federal and state courts issued opinions during this Survey period addressing the circumstances under which an insurer may deny coverage based on an insured's breach of a policy's notice or cooperation provision, including what constitutes breach of such provisions, whether the insurer is required to show prejudice from the breach, and, if so, what evidence is necessary to establish prejudice.

1. *The Fifth Circuit Certified Questions to the Texas Supreme Court Concerning the Application of a Notice Requirement to an Additional Insured*

In *Crocker v. National Union Fire Insurance Co.*,⁷⁰ the Fifth Circuit analyzed whether an additional insured's failure to comply with the policy's notice requirement barred coverage. The general-liability policy was issued to the employer as the named insured and provided coverage for its employee as an additional insured. The insurer had provided a defense in the underlying suit for the employer but not for the employee, since the latter had not notified the insurer of the suit or requested a defense from the insurer. The claimant obtained a default judgment against the employee and sought recovery under the policy. It was undis-

66. *Id.*

67. *Id.* at 100-01.

68. *Id.* at 101-02.

69. *Id.* at 102.

70. 466 F.3d 347 (5th Cir. 2006), *cert. granted*, No. 06-0868, 2006 Tex. LEXIS 1035 (Oct. 13, 2006).

puted that the claims against both the employer and the employee were covered under the policy. The insurer knew the employee was a named defendant in the suit, and knew or should have known, that he had been served. The employee was not aware of the policy, did not know he was an additional insured, did not forward the suit papers to the insurer or otherwise inform it that he had been sued, and did not request a defense from the insurer or the employer. The insurer did not inform the employee that he was an additional insured and did not offer to defend him.⁷¹

The Fifth Circuit began its analysis with *Weaver v. Hartford Accident and Indemnity Co.*,⁷² where the Texas Supreme Court determined that an additional insured's ignorance of the policy did not excuse its failure to comply with the policy's notice-of-suit provision.⁷³ The Fifth Circuit explained that if it applied *Weaver* to the case before it, then the employee's ignorance of his rights and obligations under the policy would be no excuse for his failure to comply with the notice provisions, the insurer would have had no duty to inform him of his rights and obligations as an additional insured, and the insurer's actual and timely notice of the accident and the suit would not have satisfied the purposes of the notice provision because the insurer did not know that it was expected to defend the employee. The Fifth Circuit, however, decided that subsequent changes in Texas insurance law raised the question of whether *Weaver* controlled.⁷⁴

The Fifth Circuit identified the principal change in Texas insurance law as the 1973 Order by the State Board of Insurance mandating an endorsement for all general liability policies requiring that an insurer be prejudiced by an insured's failure to provide notice before it can avoid liability due to such failure.⁷⁵ After reviewing numerous subsequent federal and state cases, the Fifth Circuit determined that, with the requirement for an insurer to show prejudice to avoid liability in certain cases, the landscape of Texas insurance law had changed in some respects since *Weaver*, but that questions remained as to just how the law had changed as applied to the present facts.⁷⁶ In the absence of controlling Texas Supreme Court precedent on the determinative legal issues, the Fifth Circuit decided to certify the following questions to the supreme court:

1. Where an additional insured does not and cannot be presumed to know of coverage under an insurer's liability policy, does an insurer that has knowledge that a suit implicating policy coverage has

71. *Id.* at 347, 348-50.

72. *Weaver v. Hartford Accident & Indem. Co.*, 570 S.W.2d 367 (Tex. 1978).

73. *Crocker*, 466 F.3d at 351-53 (citing *id.* at 368-70).

74. *Id.* at 353-54.

75. *Id.* at 354 (citing *Chiles v. Chubb Lloyds Ins. Co.*, 858 S.W.2d 633, 635 (Tex. App.—Houston [1st Dist.] 1993, writ denied) (quoting State Bd. of Ins., Revision of Texas Standard Provision For General Liability Policies—Amendatory Endorsement—Notice, Order No. 23080 (Mar. 13, 1973))).

76. *Id.* at 358-59.

been filed against its additional insured have a duty to inform the additional insured of the available coverage?

2. If the above question is answered in the affirmative, what is the extent or proper measure of the insurer's duty to inform the additional insured, and what is the extent or measure of any duty on the part of the additional insured to cooperate with the insurer up to the point he is informed of the policy provisions?

3. Does proof of an insurer's actual knowledge of service of process in a suit against its additional insured, when such knowledge is obtained in sufficient time to provide a defense for the insured, establish as a matter of law the absence of prejudice to the insurer from the additional insured's failure to comply with the notice-of-suit provisions of the policy?⁷⁷

2. *The Issue of Compliance with a Notice Provision Is Evaluated under an Objective Standard of Reasonableness*

In *Blanton v. Vesta Lloyds Insurance Co.*,⁷⁸ the notice provision of the general liability policy required the insured to notify the insurer "as soon as practicable of an 'occurrence' or an offense which may result in a claim."⁷⁹ The Dallas Court of Appeals explained that the issue of whether the insured complied with this provision is not evaluated from the insured's subjective perspective, but rather, under the objective standard of reasonable prudence that requires the insured to give notice "as soon as notice would have been given by an ordinary prudent person in the exercise of ordinary care in the same or similar circumstances."⁸⁰ What constitutes a reasonable time for giving notice depends on the individual facts and circumstances of each particular case, including the insured's age, experience, and capacity for understanding and knowing that coverage exists in its favor. But an insured has no duty to report an occurrence if, after the insured has fully acquainted itself with all the facts surrounding the occurrence, it appears that the occurrence was of such a nature that it could not reasonably be expected to result in any claim or liability.⁸¹

Reviewing the evidence under this objective standard, the court of appeals concluded that the insured breached the policy's notice provision.⁸² Specifically, the evidence showed that the claimant first complained to the insured about roof leaks in the property he had leased from the in-

77. *Id.* at 359; *see also* First Prof'l Ins. Co. v. Heart & Vascular Inst. of Tex. 182 S.W.3d 6, 10–14 (Tex. App.—San Antonio 2005, pet. denied) (concluding that, under a claims-made policy, notice to the insurer of claims made against two physicians practicing in the same medical group did not constitute timely notice of a claim against the group itself, where the policy required notice of "claims," not a liability "event," and where the letters from the claimants that were forwarded to the insurer did not assert a claim against the group).

78. 185 S.W.3d 607 (Tex. App.—Dallas 2006, no pet.).

79. *Id.* at 611.

80. *Id.* at 611, 614.

81. *Id.* at 611–12.

82. *Id.* at 615.

sured within six or eight months after moving in; the claimant complained “pretty consistently” about the roof leaks during the entire course of his tenancy; and the insured received about thirty complaints from the claimant, which were far in excess of the complaints the insured had received on his other properties.⁸³ Nevertheless, the insured did not notify the insurer of the occurrence until after he was served in the suit brought by the claimant, which was over two and half years after the claimant’s first complaint. Emphasizing that lack of knowledge that a claim could be made is not an excuse for failing to comply with a notice provision, the court of appeals found that the evidence did not establish excuse because it did not show that the insured made a full, complete, and fair investigation of all the facts and surrounding circumstances of the “excessive” complaints to reasonably conclude that the occurrence was of such a nature that it could not reasonably be expected to result in any claim or liability.⁸⁴

Evaluating whether the insurer was prejudiced by the insured’s late notice, the court of appeals instructed that a showing of prejudice generally requires a showing that one of the recognized purposes of the notice requirement has been impaired. One such purpose is to enable the insurer to investigate the circumstances of an occurrence while the matter is fresh in the witnesses’ minds so that the insurer can adequately prepare to adjust or defend any subsequent claims.⁸⁵ The insured argued that the insurer was not prejudiced because it was not prevented from conducting discovery during the suit and because it received notice prior to the entry of a judgment. Rejecting this argument, the court of appeals emphasized that “prejudice from failure to notify timely arises from inability to investigate the circumstances of an occurrence to prepare adequately to adjust or defend any claims, not merely to prepare for trial.”⁸⁶ Because the insured’s evidence failed to address the insurer’s inability to conduct a timely investigation, the court of appeals concluded that the insured had failed to raise a fact issue as to prejudice and, therefore, that the trial court had properly granted summary judgment in favor of the insurer.⁸⁷

3. *An Insured Does Not Satisfy a Notice Requirement by Notifying Its Agent*

In *Executive Risk Indemnity, Inc. v. First State Bank, N.A.*,⁸⁸ the in-

83. *Id.* at 612, 615.

84. *Id.* at 609, 613, 614–15.

85. *Id.* at 611–12.

86. *Id.* at 615.

87. *Id.* *But cf.* *Gibbons-Markey v. Tex. Med. Liab. Trust*, 163 F. App’x 342, 344–46 (5th Cir. 2006) (despite a five-month delay from the time the insured learned of the default judgment and when she notified the insurer, the Fifth Circuit concluded that the supreme court would not find an insurer prejudiced as a matter of law by a post-default notice where the insured was also unaware of the suit until after default had been entered, and that the insurer had not shown prejudice under the specific facts of the case because there was viable post-judgment relief still available at the time the insurer received notice).

88. No. 3:05-CV-0051-D, 2006 WL 42359 (N.D. Tex. Jan. 9, 2006).

sured argued that the insurer received reasonable notice because the insured sent the claim to an insurance agent whom the insurer and insured had established as a “go-between contact,” and this agent’s knowledge of the claim became the insurer’s knowledge constructively, regardless of whether the agent had actually communicated this knowledge to the insurer.⁸⁹ In rejecting this argument, the United States District Court for the Northern District of Texas explained that, under Texas law, an insurance agent can act as an agent for both the insured and the insurer. Generally speaking, an agent acts for the insured in making applications and in processing the policy and, on the other hand, acts for the insurer in delivering the policy and in collecting and remitting premiums.⁹⁰ While such agency issues are usually questions of fact, the district court determined that there was no question of fact here because the insured’s own statements identified the agent as its agent, not an agent of the insurer. The district court therefore concluded that this notice to the agent did not constitute notice to the insurer, and that the notice given directly to the insurer twenty-eight months after the claim was first made was not given as soon as practicable.⁹¹

4. *No Coverage for Settlement Reached Without Notice to or Consent from the Insurer*

In *Motiva Enterprises, L.L.C. v. St. Paul Fire and Marine Insurance Co.*,⁹² the Fifth Circuit concluded that the insurer was not required to reimburse the insured for a settlement it had paid without giving notice to or obtaining consent from the insurer.⁹³ The policy at issue contained a standard consent-to-settle clause requiring the insurer’s advance consent to any settlements that it would be funding as well as a standard cooperation clause requiring the insured to cooperate with the insurer in the investigation, settlement, and defense of claims.⁹⁴ The insured requested that the insurer attend a mediation in an underlying suit, but the insured later refused the insurer’s request for documents pertaining to the suit and asked the insurer’s representative to leave the mediation before it had concluded. The mediation continued without the insurer’s presence, and the insured reached a settlement. The insured asked the insurer to fund the settlement, but the insurer refused on the ground that its consent had not been obtained. The insured paid the settlement out of its own funds and sued the insurer for reimbursement.⁹⁵

Relying on the Fifth Circuit’s decision in *Rhodes v. Chicago Insurance Co.*⁹⁶ the insured argued that because the insurer’s tender of a defense

89. *Id.* at *2.

90. *Id.*

91. *Id.* at *1–2.

92. 445 F.3d 381 (5th Cir. 2006) (op. on reh’g).

93. *Id.* at 383.

94. *Id.*

95. *Id.* at 383–84.

96. 719 F.2d 116 (5th Cir. 1983).

was not unqualified (*i.e.*, the tender was subject to a reservation of rights to later deny coverage), it was entitled to settle the suit without consulting the insurer.⁹⁷ The Fifth Circuit disagreed, explaining that its holding in *Rhodes* was an “Erie guess,” had since been undermined by the Texas Supreme Court’s decision in *State Farm Lloyds Insurance Co. v. Maldonado*,⁹⁸ and did not accurately reflect current Texas law.⁹⁹ Under *Maldonado*, an insurer that tenders a defense with a reservation of rights is entitled to enforce a consent-to-settle clause.¹⁰⁰ The Fifth Circuit concluded that the trial court did not err in holding that the insured had breached the policy by settling without the insurer’s consent.¹⁰¹

The insured next argued that even if it breached the consent-to-settle clause, the insurer could not refuse to pay policy benefits unless it shows actual prejudice from the breach. The Fifth Circuit noted, “it is not entirely clear under Texas law whether an insurer must demonstrate prejudice before it can avoid its obligations under a policy where the insured breaches a prompt-notice provision or a consent-to-settle provision.”¹⁰² Assuming, without deciding, that an insurer must show prejudice, the Fifth Circuit stated that it was satisfied that the insurer suffered prejudice as a matter of law. Emphasizing that “[a]n insurer’s right to participate in the settlement process is an essential prerequisite to its obligation to pay a settlement,” the Fifth Circuit decided that when, as in this case, the insurer is not consulted about the settlement, the settlement is not tendered to the insurer, and the insurer has no opportunity to participate in or consent to the ultimate settlement decision, then the insurer is prejudiced as a matter of law.¹⁰³ Accordingly, the Fifth Circuit concluded that the insured’s breach of the consent-to-settle provision barred its action against the insurer and, therefore, the insurer had no obligation to reimburse the insured for the settlement.¹⁰⁴

97. *Motiva Enters.*, 445 F.3d at 384 (referencing *Rhodes*, 719 F.2d at 116 (stating that if the insurer reserved its rights and the insured elected to pursue its own defense, the insurer was bound to pay covered damages that were reasonable and prudent up to the policy limits)).

98. 963 S.W.2d 38 (Tex. 1998).

99. *Motiva Enters.*, 445 F.3d at 385 (citing *Maldonado*, 963 S.W.2d at 40).

100. *Maldonado*, 963 S.W.2d at 40.

101. *Id.*

102. *Id.* at 386.

103. *Id.*

104. *Id.* at 383, 387. The Fifth Circuit’s decision was issued on March 28, 2006. On July 21, 2006, the Fifth Circuit issued a supplemental opinion upon its denial of the petition for rehearing. *Motiva Enters., LLC v. St. Paul Fire & Marine Ins. Co.*, 457 F.3d 459, 459 (5th Cir. 2006). As an alternate basis for its conclusion that the insured could not recover from the insurer, the Fifth Circuit highlighted the policy provision providing that the insurer has no liability unless “the amount you owe has been determined with our consent or by actual trial and final judgment.” *Id.* at 459–60. *Maldonado* stood for the proposition that such a policy provision is a condition precedent to coverage. Because the insured sought recovery of a sum paid in settlement without the consent of the insurer, the Fifth Circuit concluded that the insured had failed to establish a condition precedent to coverage and, therefore, that *Maldonado* precluded the insured’s recovery. *Id.* at 460.

5. *An Insured's Failure to Cooperate in the Defense Can Preclude Coverage*

In *Progressive County Mutual Insurance Co. v. Trevino*,¹⁰⁵ the San Antonio Court of Appeals interpreted a policy provision requiring that a person who seeks coverage must cooperate in the investigation, settlement, or defense of any claim or suit. The court of appeals determined that the language of this provision was nearly identical to the policy language addressed in *Harwell v. State Farm Mutual Automobile Insurance Co.*¹⁰⁶ and, therefore, held that this cooperation clause was a condition precedent to coverage.¹⁰⁷ The court of appeals explained that even though there was no evidence that this condition precedent was satisfied, the insurer could not escape liability unless it was prejudiced by the lack of cooperation.¹⁰⁸ The evidence showed that the insured did not cooperate with his defense, filed a pro se answer and frivolous counterclaim despite having counsel hired by the insurer to represent him, adamantly refused to have the insurer pay on the claim, and indicated to the insurer through a message from his guardian that he did not intend to be involved in the suit at all. Given this evidence, the court of appeals determined that the lawyer hired by the insurer to represent the insured "was simply not permitted to appear on [the insured's] behalf in court."¹⁰⁹ As such, the lawyer was prevented from mounting a defense to limit the liability and damages, from stopping the entry of the default judgment, and from seeking a new trial or appellate relief. Based on these facts, the court of appeals concluded that the insurer was prejudiced as a matter of law by the insured's lack of cooperation and rendered a take-nothing judgment in favor of the insurer.¹¹⁰

D. CGL POLICIES

1. *The Texas Supreme Court Is Considering Whether Construction Defect Claims Allege an "Occurrence" and "Property Damage" Triggering Coverage under CGL Policies*

Insurers, insureds, and courts continue to struggle in determining whether claims for defective workmanship allege an "occurrence" and "property damage" sufficient to trigger coverage under a commercial general liability ("CGL") policy.¹¹¹ For example, in *Century Surety Co. v. Hardscape Construction Specialties, Inc.*,¹¹² the United States District

105. 202 S.W.3d 811 (Tex. App.—San Antonio 2006, pet. filed).

106. 896 S.W.2d 170 (Tex. 1995).

107. *Trevino*, 202 S.W.3d at 815–16 (citing *Harwell*, 896 S.W.2d at 173–74).

108. *Id.* at 816.

109. *Id.* at 817.

110. *Id.* at 817–18, 820.

111. See generally *Pine Oak Builders, Inc. v. Great Am. Lloyds Ins. Co.*, No. 14-05-00487-CV, 2006 WL 1892669, at *3 (Tex. App.—Houston [14th Dist.] July 6, 2006, no pet.) ("The issue of whether CGL policies cover claims for defective construction is currently a contentious issue in Texas and nationally.")

112. No. 4:05-CV-285-Y, 2006 U.S. Dist. LEXIS 47563 (N.D. Tex. July 27, 2006).

Court for the Northern District of Texas determined that the insurer had no duty to defend an underlying construction defect claim against the insured because the claim arose from contractual obligations owed by the insured and did not constitute an “occurrence” under the policy. Specifically, the underlying suit alleged claims for negligence, gross negligence, breach of contract, and breach of implied and express warranties arising from the construction of two swimming pools by the insured.¹¹³ The insurer denied coverage asserting that the construction errors did not constitute an “occurrence,” defined in the policy as “an accident, including continuous or repeated exposure to substantially the same general harmful conditions.”¹¹⁴ The district court agreed with the insurer, finding that the claims arose from the insured’s “duties to provide design, construction and engineering services, which were purely contractual duties” and that the insured’s “injury was that the pools it was promised and paid for were not the pools it received, which is not an ‘occurrence’ under the policy.”¹¹⁵

Conversely, in *Home Owners Management Enterprises, Inc. v. Mid-Continent Casualty Co.*,¹¹⁶ the same district court determined that claims of foundation damage caused by the insured’s negligence did constitute an “occurrence” under a CGL policy.¹¹⁷ In reaching this decision, the district court noted that the underlying plaintiffs did not allege that the insured intended to cause foundation damage but claimed that the insured negligently caused the damage.¹¹⁸ The district court concluded that “[a]n allegation of negligence constitutes an accidental ‘occurrence’ under the policy and is sufficient to trigger” the insurer’s duty to defend.¹¹⁹

These cases are illustrative of the ongoing conflict regarding these issues. Fortunately, the Texas Supreme Court may finally resolve this quagmire, as these issues have been certified by the Fifth Circuit. In *Lamar Homes, Inc. v. Mid-Continent Casualty Co.*,¹²⁰ the Fifth Circuit explained that some courts have found that construction errors do not constitute an “occurrence,” concluding that a claim for defective workmanship is really a claim for breach of contract, which is not covered, and reasoning that shoddy work is foreseeable by the contractor and, therefore, is not an accidental or unexpected loss.¹²¹ However, other courts

113. *Id.* at *4.

114. *Id.* at *11.

115. *Id.* at *13. *See also* Grimes Constr., Inc. v. Great Am. Lloyds Ins. Co., 188 S.W.3d 805, 811 (Tex. App.—Fort Worth 2006, pet. filed) (concluding that negligence allegations were simply a “recharacterization” of basic breach of contract and warranty claims).

116. No. 3:04-CV-2061-BF, 2005 U.S. Dist. LEXIS 22524 (N.D. Tex. 2005).

117. *Id.* at *10; *see also* Summit Custom Homes, Inc. v. Great Am. Lloyds Ins. Co., 202 S.W.3d 823, 830 (Tex. App.—Dallas 2006, pet. filed) (holding that “[t]here is an ‘occurrence’ if an action is intentionally taken, but negligently performed, and the damages are unexpected or unintended”).

118. 2005 U.S. Dist. LEXIS 22524, at *16.

119. *Id.*

120. 428 F.3d 193 (5th Cir. 2005).

121. *Id.* at 196-97.

have found an “occurrence” in this circumstance, reasoning that where the shoddy workmanship is the result of the insured’s negligence, rather than intentional conduct, the loss is unexpected and, thus, accidental.¹²²

Texas state and federal courts are also in disagreement concerning whether damage caused by defective workmanship constitutes “property damage” under a CGL policy. Some courts have determined that such claims do not allege “property damage,” reasoning that claims for the cost of repairing faulty workmanship are claims for pure economic loss. Such claims do not constitute damage from “physical injury to tangible property,” as usually required by CGL policies, and typically flow from a breach of contract.¹²³ These courts reason that CGL policies do not insure against business risks since; to do so, would result in there being little difference between a CGL policy and a performance bond.¹²⁴ In contrast, other courts have concluded that when construction errors cause physical damage to property, that damage constitutes “property damage” covered under a CGL policy regardless of whether the only “tangible property” that is damaged is the property that is the object of the contract.¹²⁵

Because of the frequency with which these issues are litigated and the conflicting rulings by both the Texas courts of appeals and the federal district courts, the Fifth Circuit certified to the Texas Supreme Court the issues of whether a construction defect claim by a homeowner alleging only damage to or loss of use of the home itself alleges an “occurrence” and “property damage” sufficient to trigger the duty to defend or indemnify under a CGL policy.¹²⁶ The Texas Supreme Court accepted this case on November 4, 2005, and heard oral argument on February 14, 2006, but has yet to issue an opinion. For now, these issues likely will continue to present problems for insureds and insurers alike.

2. *Courts Disagree Over the Test for Determining When Property Damage “Occurred”*

In addition to the conflict over whether construction defect claims allege an “occurrence” and “property damage,” Texas courts also disagree about the proper test to be applied in determining whether allegations of ongoing or continuous property damage meet the requirement that the property damage must “occur” during the policy period to trigger coverage under a CGL policy. The United States District Court for the Southern District of Texas explained that the Texas Supreme Court has identified five tests for determining when coverage is triggered for “continuing occurrences”: (1) the pure or strict manifestation rule, deeming coverage triggered by actual discovery of the injury; (2) the relaxed mani-

122. *Id.* at 197.

123. *Id.* at 198.

124. *Id.*

125. *Id.*

126. *Id.* at 199, 200–01.

festation rule, deeming coverage triggered in the first policy period during which discovery is possible; (3) the exposure rule, deeming coverage triggered in any policy period when exposure to the cause occurred; (4) the injury-in-fact rule, deeming coverage triggered in personal injury cases when the “body’s defenses are ‘overwhelmed’”; and (5) the multiple or triple-trigger approach, requiring coverage during period of continuing exposure and manifestation.¹²⁷ To date, the supreme court has not adopted a specific trigger test, and some disagreement remains among Texas courts of appeals.¹²⁸

The district court further explained that despite unsettled Texas law, the Fifth Circuit has taken a definitive position that the manifestation theory applies to determine when coverage is triggered for property damage claims.¹²⁹ The district court decided that, in the absence of guidance from the supreme court, it was bound by Fifth Circuit precedent and applied the manifestation rule.¹³⁰ Based on the homeowners’ allegations that the mold and mildew became noticeable to them in 2001, the district court concluded that the property damage manifested in 2001, that there was no property damage that occurred during the 1996-97 policy period, and that the allegations did not trigger coverage under the CGL policy.¹³¹

The Dallas Court of Appeals also follows the manifestation rule.¹³² The court of appeals explained that in its prior *Dorchester Development Corp. v. Safeco Insurance Co.*¹³³ decision, it had addressed the issue of whether coverage exists for property damage that is caused by work performed during the policy period, but that does not manifest until after the policy period, and held that no coverage exists unless the property damage manifests itself, or becomes apparent, during the policy period.¹³⁴ While noting that a sister court of appeals refused to follow *Dorchester* and rejected the manifestation rule, the court of appeals declined the insured’s request to revisit *Dorchester* and continued to apply the manifestation rule.¹³⁵

In contrast, the Houston Court of Appeals rejected a blanket adoption of the manifestation rule for all property damage claims and, instead, decided that the exposure rule applied in certain circumstances.¹³⁶ Dis-

127. *Bayou Bend Homes, Inc. v. Scottsdale Ins. Co.*, No. H-05-1544, 2006 WL 2037564, at *6 (S.D. Tex. July 18, 2006) (citing *Am. Physicians Ins. Exch. v. Garcia*, 876 S.W.2d 842, 853 n.20 (Tex. 1994)).

128. *Id.*

129. *Id.* at *7 (citing *Guar. Nat’l Ins. Co. v. Azrock Indus.*, 211 F.3d 239, 248 (5th Cir. 2000)).

130. *Id.*

131. *Id.*

132. *Summit Custom Homes, Inc.*, 202 S.W.3d at 827.

133. 737 S.W.2d 380, 383 (Tex. App.—Dallas 1987, no writ).

134. *Summit Custom Homes, Inc.*, 202 S.W.3d at 827 (citing *Dorchester Dev. Corp.*, 737 S.W.2d at 383).

135. *Id.* (referring to *Pilgrim Enters., Inc. v. Md. Cas. Co.*, 24 S.W.3d 488 (Tex. App.—Houston [1st Dist.] 2000, no pet.)).

136. *Pine Oak Builders, Inc. v. Great Am. Lloyds Ins. Co.*, No. 14-05-00487-CV, 2006 WL 1892669, at *7-9 (Tex. App.—Houston [14th Dist.] July 6, 2006, no pet.).

agreeing with the insured's assertion that Texas courts have consistently adopted the manifestation rule, the court of appeals stated that only two courts have adopted this rule and that the Texas Supreme Court has thus far declined to adopt or reject it.¹³⁷ The court of appeals further explained that none of the cases adopting the manifestation rule involved the same language as that in the CGL policies that the court was interpreting, which defined the term "occurrence" as including "continuous or repeated exposure to conditions."¹³⁸ This language, however, was considered in *Pilgrim Enterprises*, which rejected the manifestation rule in favor of the exposure rule.¹³⁹ Emphasizing that the policies at issue omitted reference to "manifestation," but did contain the "continuous or repeated exposure" language, the court of appeals determined that any property damage that occurred because of continuous or repeated exposure to conditions during the policy period of a policy issued by the two insurers was potentially covered.¹⁴⁰ The court of appeals therefore concluded that each insurer had a duty to defend any claim alleging potential property damage from a continuous or repeated exposure falling within a relevant policy period.¹⁴¹

3. *The "Business-Risks" Exclusions*

In *Summit Custom Homes, Inc. v. Great American Lloyds Insurance Co.*,¹⁴² the Dallas Court of Appeals interpreted the standard exclusions in CGL policies known as the "business-risks" exclusions.¹⁴³ Specifically, the "your-work" exclusion precludes coverage for "'property damage' to 'your work' arising out of it or any part of it and included in the 'products-completed operations hazard.'"¹⁴⁴ The court of appeals explained that the "your-work" exclusion generally bars coverage for "property damage" to the insured's work arising after the owner has finished a construction project has taken possession.¹⁴⁵ 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."¹⁴⁶

The court of appeals reasoned that the insurance industry's 1986 incorporation of the "subcontractor exception" in the "your-work" exclusion of the standard CGL policy "demonstrate[s] that insurers intended to cover some defective construction resulting in damage to the insured's work."¹⁴⁷ Based on this reasoning, the court of appeals summarized the

137. *Id.* at *7.

138. *Id.*

139. *Id.* (citing *Pilgrim Enters.*, 24 S.W.3d at 496).

140. *Id.* at *8.

141. *Id.*

142. 202 S.W.3d 823 (Tex. App.—Dallas 2006, pet. filed).

143. *Id.* at 829–30.

144. *Id.*

145. *Id.*

146. *Id.* at 830.

147. *Id.*

relationship among the “occurrence” requirement, the “your-work” exclusion, and the “subcontractor exception” of a CGL policy as follows:

[N]egligently created, or inadvertent, defective construction resulting in damage to the insured’s own work that is unintended and unexpected can constitute an “occurrence.” Nonetheless, the “your work” or other “business risk” exclusions may preclude coverage for the damage. However, in some instances, coverage will be restored if the damaged work, or the work out of which the damage arose, was performed by subcontractors.¹⁴⁸

Because the insured’s work that was alleged to be defective (exterior finishing on the house referred to as “EIFS”) had been installed and applied by subcontractors, the “your work” exclusion did not apply to preclude coverage for this claim.¹⁴⁹

4. *The “Construction-Defect” Exclusion*

In *Primary Plumbing Services, Inc. v. Certain Underwriters at Lloyd’s London*,¹⁵⁰ the Houston Court of Appeals for the First District interpreted a policy exclusion that expressly stated that coverage was excluded for “‘any claim for loss or damage, including defense cost, *involving* construction defect(s) caused or contributed by the insured, employees of the insured or subcontractors of the named insured.’”¹⁵¹ The claimant in the underlying suit alleged that the insured did not install a wall-hung lavatory properly, that the insured’s failure to follow proper plumbing practices in installing the lavatory constituted negligence, and that she was injured as a result of the insured’s negligence.¹⁵² The insured first argued that the “construction defect” exclusion did not apply because the claim was for bodily injury and not a construction defect. The court of appeals, however, disagreed, explaining that the exclusion contained no language limiting its application to certain types of claims or certain types of damages but instead broadly applied to any claim for loss or damage. The court of appeals determined that the claim seeking recovery for bodily injury was a claim for damage to which the exclusion applied.¹⁵³

The insured next argued that the exclusion did not apply because the underlying pleading alleged negligence in the installation of the lavatory, and “installation has nothing to do with construction.”¹⁵⁴ Rejecting this

148. *Id.* (quoting *Lennar Corp. v. Great Am. Ins. Co.*, 200 S.W.3d 651, 675 (Tex. App.—Houston [14th Dist.] 2006, pet. filed); accord *Pine Oak Builders, Inc.*, 2006 WL 1892669, at *4 (following *Lennar*, explaining that an allegation of faulty construction performed by a subcontractor on the insured’s behalf is “a prerequisite to coverage under the CGL policies’ subcontractor exception to the ‘your-work’ exclusion” and determining that the standard CGL policy provides coverage for property damage caused by defective construction performed by a subcontractor).

149. *Id.*

150. No. 01-05-00135-CV, 2006 Tex. App. LEXIS 718 (Tex. App.—Houston [1st Dist.] Jan. 26, 2006, pet. denied).

151. *Id.* at *11.

152. *Id.* at *3–4.

153. *Id.* at *10–11.

154. *Id.* at *11–12.

argument, the court of appeals noted that the policy did not define the term “construction defect,” and, thus, the court had to give the term its plain meaning found in the various dictionary definitions of the word “construction.”¹⁵⁵ The court of appeals found that regardless of the pleading’s use of the specific word “installation,” the factual allegations showed that the claimant was essentially alleging that the insured negligently constructed, built, or assembled the lavatory.¹⁵⁶ The court of appeals reasoned that by including an exclusion that, by its terms, applied to any claim for loss or damage involving a construction defect, the parties intended to exclude coverage for any claim for loss or damage arising out of the insured’s construction, assembly, or installation of plumbing fixtures; there was nothing in the exclusion that suggested it did not apply to a claim for bodily injury as a result of the insured’s negligent or substandard “installation.”¹⁵⁷ Accordingly, the court of appeals concluded that the claimant’s alleged injuries constituted a loss or damage involving a construction defect caused or contributed by the insured, that the construction defect exclusion unambiguously applied to the underlying claim, and, that the insurer did not owe a duty to defend.¹⁵⁸

E. HOMEOWNERS POLICIES

In *Fiess v. State Farm Lloyds*,¹⁵⁹ the Texas Supreme Court, answering a certified question from the Fifth Circuit, held that the “ensuing-loss clause” in the standard Texas Homeowners Form B (“HO-B”) policy does not provide coverage for mold contamination caused by water damage that is otherwise covered under the policy.¹⁶⁰ The supreme court began its opinion by emphasizing that its decision had to be based solely on the policy’s language and could not be affected by outside views concerning a “mold crisis” in Texas:

The question in this case is not whether insurers should provide mold coverage in Texas, a public policy question beyond our jurisdiction as a court. The question instead is whether the language in an insurance policy provides such coverage—no more and no less.

The rules for construing insurance policies have been around for a longtime, long before this dispute arose. Those rules require us to construe a policy according to what it says, not what regulators or individual insurers thought it said. Ambiguities in the plain language must be settled in favor of consumers, but they must appear in the policy itself—we cannot create ambiguities from previous policies, an agency’s interpretation, or a “mold crisis.”

The policy here provides that it does not cover “loss caused by mold.” While other parts of the policy sometimes make it difficult to

155. *Id.* at *12.

156. *Id.*

157. *Id.* at *12–13.

158. *Id.* at *14–15.

159. 202 S.W.3d 744 (Tex. 2006).

160. *Id.* at 745–46.

decipher, we cannot hold that mold damage is covered when the policy expressly says it is not.¹⁶¹

The policy exclusion in question stated: “We do not cover loss caused by: . . . (2) rust, rot, mold or other fungi. . . . We do cover ensuing loss caused by . . . water damage . . . if the loss would otherwise be covered under this policy.”¹⁶² In interpreting this language, the supreme court reiterated the longstanding rule that all parts of a policy must be read together, “giving meaning to every sentence, clause, and word to avoid rendering any portion inoperative.”¹⁶³ Although this exclusion ends with, “We do cover ensuing loss caused by water damage,” the supreme court emphasized that it “cannot overlook the obvious—that the policy provision here begins by stating unambiguously, ‘We do not cover loss caused by mold.’”¹⁶⁴

The supreme court explained that in *Lambros v. Standard Fire Insurance Co.*,¹⁶⁵ the San Antonio Court of Appeals decided that for coverage to exist pursuant to the ensuing-loss clause, the water damage must be the *result*, rather than the *cause*, of the types of damage enumerated in the exclusion, such as mold.¹⁶⁶ Because the application for writ of error was refused, *Lambros* has the same force and effect as a supreme court decision.¹⁶⁷ The supreme court explained that acceptance of the interpretations offered by both the insured and the Texas Department of Insurance would require it to overrule *Lambros*. Because a quarter century had passed since *Lambros* without the insurance regulators making any change to the policy, the supreme court declined the “invitation” to overrule *Lambros*.¹⁶⁸

Examining the overall purpose of a homeowners policy, the supreme court further explained that because the excluded risks—mold, wear and tear, termites, etc.—damage a house incrementally and are very common, construing the policy to cover all these risks “would convert it from an insurance policy into a maintenance agreement.”¹⁶⁹ Instead, the ensuing-loss clause must be intended to provide coverage “only if these relatively common and usually minor risks lead to a relatively uncommon and perhaps major loss: building collapse, glass breakage, or water damage.”¹⁷⁰ The supreme court found that ordinary people would read the clause as providing coverage “for the kinds of uncommon and catastrophic losses

161. *Id.* at 745.

162. *Id.* at 746.

163. *Id.* at 748.

164. *Id.*

165. 530 S.W.2d 138 (Tex. Civ. App.—San Antonio 1975, writ ref’d).

166. *Fiess*, 202 S.W.3d at 748–49 (citing *Lambros*, 530 S.W.2d at 141).

167. *Id.* at 749.

168. *Id.* at 749–50; *see also* *Lundstrom v. United Servs. Auto. Ass’n*, 192 S.W.3d 78, 94–95 (Tex. App.—Houston [14th Dist.] 2006, pet. denied) (concluding, *pre-Fiess*, that regardless of whether the court agreed with *Lambros*, it was bound to follow that case as supreme court precedent, and that, under *Lambros*, the mold damage, which followed rather than preceded the water damage, was excluded from coverage).

169. *Id.* at 750.

170. *Id.*

for which homeowners obtain insurance, not for the uncommon maintenance items for which they do not.”¹⁷¹ The supreme court further noted that the insureds’ argument that an ensuing-loss clause can make an excluded loss (here, mold) reappear as a covered loss had been rejected by numerous courts in other states and that interpreting the policy as covering mold “would give ensuing-loss clauses in Texas a different meaning from what they have in most other American jurisdictions.”¹⁷²

For these reasons, the supreme court concluded that the ensuing-loss clause could not be interpreted as providing coverage for mold and, therefore, answered “No” to the certified question.¹⁷³ In closing, the supreme court instructed, “[i]f the political branches of Texas government decide that mold should be covered in Texas insurance policies, they have tools at their disposal to do so; Texas courts must stick to what those policies say, and cannot adopt a different rule when a ‘crisis’ arises.”¹⁷⁴

F. AUTO POLICIES

In *Emcasco Insurance Co. v. American International Specialty Lines Insurance Co.*,¹⁷⁵ the insurer, under a commercial auto liability policy, brought a subrogation suit against a CGL insurer to recover amounts it paid to settle an underlying suit against a mutual insured. The underlying claimants were involved in an accident in which their car skidded on a patch of mud, clay, and/or sand, swerved off the road, and struck a tree. The claimants alleged that the mutual insured, the operator of a sand pit adjacent to the accident site, had hauled sand from the pit in trucks it owned and operated, that because of heavy rains preceding the accident, the trucks tracked mud onto the road when exiting the pit, and that the mud on the road was the producing cause of the accident. The CGL insurer denied coverage based on its policy’s exclusion for bodily injury or property damage “arising out of the ownership, maintenance, use, or entrustment to others of any . . . auto . . . owned or operated by or rented or loaned to any insured. Use includes operation and loading or unloading.”¹⁷⁶

The Fifth Circuit explained that in deciding whether a duty to indemnify exists, Texas courts use the “complete operation” theory, under which “‘provision for use coverage extends to foreseeable consequences of what was done in connection with the use of the car, . . . so long as the act or thing done by the insured’s employee which causes the accident arises out of the use of the insured’s car.’”¹⁷⁷ The “complete operation” test has two distinct inquiries: (1) whether the insured’s act was an act

171. *Id.* at 751.

172. *Id.* at 752–53.

173. *Id.* at 753.

174. *Id.*

175. 438 F.3d 519 (5th Cir. 2006).

176. *Id.*

177. *Id.* at 524 (quoting *Red Ball Motor Freight v. Employers Mut. Liab. Ins. Co.*, 189 F.2d 374, 377 (5th Cir. 1951)).

incident to, and having a connection with, the use of the auto; and (2) whether that act proximately caused the claimant's injury.¹⁷⁸

Addressing the first inquiry, the Fifth Circuit further explained that Texas courts have read business auto policies to cover loading and unloading of the covered vehicle, even if that is not specifically mentioned in the text of the policy. Loading and unloading has been interpreted to cover acts incident to making a commercial delivery, including the entire process involved in moving the articles from the place where the insured's employees find the articles to the place where the employees turn the articles over to the party to whom the articles are being delivered.¹⁷⁹ While noting that Texas courts have never decided whether mud, clay, sand, or other debris tracked by a truck's tires or fallen from its cargo, are incident to its use, the Fifth Circuit concluded that, based on "the broad interpretation Texas courts have given to what is incident to the use of an automobile," such debris is indeed incident to the use of the truck.¹⁸⁰ In reaching this conclusion, the Fifth Circuit reasoned that debris falling from a vehicle's cargo is incident to the transportation of that cargo, and it is inherent that in the transportation of cargo that some of it may spill or fall onto the road. Further, the tracking of debris by tires is incident to the operation of a vehicle on unpaved roads, as it is inherent in driving on unpaved roads that some sand, mud, or clay may attach to the tires.¹⁸¹ The Fifth Circuit also rejected a requirement of contemporaneous use of the vehicle and instead concluded, "[t]he accident need not be contemporaneous with the use of the vehicle so long as it is a foreseeable consequence of an act incidental to the use of the vehicle, such as the tracking of debris."¹⁸²

Having concluded that the first part of the test had been met (*i.e.*, the tracking of mud onto the road was incident to the use of the vehicle), the Fifth Circuit turned to the second issue of whether the tracking of mud onto the road was the proximate cause of the injuries.¹⁸³ The Fifth Circuit emphasized that the operation or driving of the vehicle need not be the proximate cause of the injuries; rather, only the act that is incident to the use of the vehicle must be the proximate cause of the injuries.¹⁸⁴ Reviewing the evidence under this standard, the Fifth Circuit decided that a genuine issue of material fact existed.¹⁸⁵ Although it was foreseeable that debris left on the road could cause an accident, it could not be determined whether the accident would not have occurred but for the tracking of the debris by the truck's tires, as rain washing the mud and sand off the unpaved road onto the public, paved road could have independently pro-

178. *Id.* at 525.

179. *Id.*

180. *Id.* at 525-26.

181. *Id.* at 526.

182. *Id.*

183. *Id.*

184. *Id.* at 527.

185. *Id.* at 528.

duced the accident.¹⁸⁶ “When two separate events—one that is excluded and one that is covered by the general liability policy—may independently have caused the accident, Texas law mandates that the general liability policy also provide coverage despite the exclusion.”¹⁸⁷ Thus, if the rain washed sufficient mud onto the road to have independently caused the accident, then the CGL policy would have covered the accident.¹⁸⁸ The Fifth Circuit concluded that the trial court’s grant of summary judgment for the CGL insurer had been improper and, therefore, remanded the case.¹⁸⁹

III. PROCEDURAL ISSUES

A. PROPRIETY OF UNDERLYING CLAIMANT AS A PARTY TO DECLARATORY JUDGMENT ACTION

In *Century Surety Co. v. Hardscape Construction Specialties, Inc.*,¹⁹⁰ the United States District Court for the Northern District of Texas decided that an underlying claimant may be a proper party to a declaratory judgment action between the insurer and the insured.¹⁹¹ The insurer initiated a declaratory judgment action against its insured and the underlying claimant, seeking a declaration that it had no duty to defend or indemnify the insured in the underlying suit. The district court noted that the purpose of the federal Declaratory Judgment Act is to “settle ‘actual’ controversies before they ripen into violations of law or breach of some contractual duty.”¹⁹² Moreover, under Texas law, the duty to indemnify is justiciable before the insured’s liability is determined in the underlying lawsuit, and a party injured by an insured is generally viewed as a third-party beneficiary of a liability policy.¹⁹³ Finding that the underlying claimant “derives its right, if any, to collect insurance proceeds directly from the rights of” the insured, the district court held that the claimant is deemed to be in privity by virtue of its shared legal interest.¹⁹⁴ The district court held that the underlying claimant was properly named as a party to the declaratory judgment action and would be bound by the determination as to coverage for the underlying claim “due to the derivative nature of its right to recovery.”¹⁹⁵

186. *Id.* at 527.

187. *Id.* at 528.

188. *Id.*

189. *Id.*

190. No. 4:05-CV-285-Y, 2006 U.S. Dist. LEXIS 47563 (N.D. Tex. July 13, 2006).

191. *Id.* at *16.

192. *Id.* (citing 28 U.S.C.A. § 2201(a)).

193. *Id.* at *15 (citing *Farmers Tex. County Mut. Ins. Co. v. Griffin*, 955 S.W.2d 81 (Tex. 1997) and *State Farm County Mut. Ins. Co. v. Ollis*, 768 S.W.2d 722 (Tex. 1989)).

194. *Id.* at *16.

195. *Id.*

B. FIFTH CIRCUIT HOLDS THAT STATE-LAW TORT CLAIMS ARE
PREEMPTED BY THE NATIONAL FLOOD
INSURANCE ACT OF 1968

In *C.W. Gallup v. Omaha Property and Casualty Insurance Co.*,¹⁹⁶ the Fifth Circuit held that the National Flood Insurance Act of 1968 expressly preempts all state-law tort claims against an insurer.¹⁹⁷ The plaintiffs asserted several state-law claims against a Write Your Own insurer under the National Flood Insurance Program, including claims for breach of contract and bad faith.¹⁹⁸ The insurer sought dismissal of the claims, arguing that the state-law claims were preempted by a December 2000 regulation promulgated by the Federal Emergency Management Agency ("FEMA") that states "all disputes arising from the handling of any claim under" the Standard Flood Insurance Policy "are governed exclusively by the flood insurance regulations issued by FEMA, the National Flood Insurance Act of 1968, and Federal common law."¹⁹⁹ The trial court denied the insurer's motion to dismiss, holding that FEMA was not authorized by Congress to preempt the application of state laws to extra-contractual claims and that preemption was inconsistent with the purposes of the Act.²⁰⁰ The Fifth Circuit reversed the trial court's denial of the insurer's motion to dismiss, holding that state-law tort claims are expressly preempted by the Act and related regulations.²⁰¹

196. 434 F.3d 341 (5th Cir. 2005).

197. *Id.* at 345.

198. *Id.* at 344.

199. *Id.* at 343.

200. *Id.* at 344.

201. *Id.* at 345.