AN UPDATE ON RECENT INSURANCE COVERAGE DECISIONS AND THEIR IMPACT ON THE CONSTRUCTION INDUSTRY:

THE POLICYHOLDERS' PERSPECTIVE

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I. The Duty to Defend Obligation, the "Eight Corners" Rule, and Extrinsic Evidence

The issue of whether extrinsic evidence is admissible to determine whether an insurer has a duty to defend has been the subject of considerable dispute in Texas. Recently, the issue has received increased attention from the highest courts in the state, including the Supreme Court of Texas and the United States Court of Appeals for the Fifth Circuit.

A. Recent Developments

In 2020, the Supreme Court of Texas issued its opinion in *Richards v. State Farm Lloyds* ("*Richards*"), rejecting arguments that the "eight corners" rule did not apply to insurance policies that did not include an obligation to defend claims even if they were "groundless, false or fraudulent"—*i.e.*, a "policy language" exception to the rule.[1] Shortly thereafter, in *Loya Insurance Company v. Avalos* ("*Avalos*"), the Supreme Court of Texas recognized a very narrow "collusive fraud" exception—the first time the Court ever adopted an exception to the "eight corners" rule.[2] In that case, the Court stated that an insurer can rely on extrinsic evidence if there is "conclusive evidence that groundless, false, or fraudulent claims against the insured have been manipulated by the insured's own hands in order to secure a defense and coverage where they would not otherwise exist."[3]

Prior to *Avalos*, the Supreme Court of Texas was presented with but declined on many opportunities to adopt (or reject) an exception to the "eight corners" rule in evaluating the duty to defend. One of the exceptions that the Court recognized on several occasions was developed by the Fifth Circuit in *Northfield Insurance Co. v. Loving Home Care, Inc*., where the Fifth Circuit stated:

> [I]f the four corners of the petition allege facts stating a cause of action which potentially falls within the four corners of the policy's scope of coverage, resolving all doubts in favor of the insured, the insurer has a duty to defend. If all the facts alleged in the underlying petition fall outside the scope of coverage, then there is no duty to defend. However, in the unlikely situation that the Texas Supreme Court were to recognize an exception to the strict eight corners rule, we conclude any exception would only apply in very limited circumstances: 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.[4]

This exception became known and referred to colloquially as the "*Northfield* Exception."

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[1] *Richards*, 597 S.W.3d 492, 499–500 (Tex. 2020).

[2] *Avalos*, 610 S.W.3d 878 (Tex. 2020).

[3] *Id*. at 882.

[4] 363 F.3d 523, 531 (5th Cir. 2004) (emphasis in original).

In *Richards*, the Supreme Court of Texas specifically referred to the *Northfield* Exception (by name) and outlined the narrow circumstances under which courts have applied it in other cases. The Court, however, declined to express an opinion on the *Northfield* Exception, noting that it was only addressing the narrow question certified as to whether a "policy language" exception exists. While the Court recognized but expressly declined to analyze the *Northfield* Exception in *Richards*, it did not even mention the *Northfield* Exception in *Avalos*.

Considering these decisions, questions existed as to whether the *Northfield* Exception remained good law. It seemed peculiar that the Supreme Court of Texas did not discuss or even mention the *Northfield* Exception in *Avalos*, which was the first time the Court held that there are circumstances when extrinsic evidence is admissible in analyzing the duty to defend. Shortly after the *Avalos* ruling, the Northern District of Texas opined on the issue in *National Liability & Fire Insurance Company v. Young*, noting that, while the Supreme Court of Texas did not address the *Northfield* Exception in *Avalos*, that rule remained binding on Texas federal district courts: "Neither Texas case law nor a change in statutory authority has displaced the Fifth Circuit's *Northfield* [E]xception."[5]

B. *Monroe Guaranty Insurance Co. v. BITCO General Insurance Corp.*, 640 S.W.3d 195 (Tex. 2022)

On February 11, 2022, the Supreme Court of Texas addressed certified questions from the Fifth Circuit, evaluating the *Northfield* Exception directly. The Fifth Circuit, in *BITCO General Insurance Corp. v. Monroe Guaranty Insurance Co*.,[6] had certified the following questions to the Supreme Court:

> 1. Is the exception to the eight-corners rule articulated in *Northfield* . . . permissible under Texas law?
> 2. When applying such an exception, may a court consider extrinsic evidence of the date of an occurrence when (1) it is initially impossible to discern whether a duty to defend potentially exists from the eight-corners of the policy and pleadings alone; (2) the date goes solely to the issue of coverage and does not overlap with the merits of liability; and (3) the date does not engage the truth or falsity of any facts alleged in the third party pleadings?[7]

The facts and issues in *BITCO* are representative of many common coverage disputes, especially in the construction industry. 5D Drilling & Pump Service Inc. ("5D") had commercial general liability insurance with BITCO General Insurance Corporation ("BITCO") for the policy periods from October 6, 2013, to October 6, 2014, and from October 6, 2014, to October 6, 2015. 5D also had insurance with Monroe Guarantee Insurance Company ("Monroe") for the policy period from October 6, 2015, to October 6, 2016.[8] The Monroe policy, however, did not apply

[5] 459 F. Supp. 3d 796, 800 (N.D. Tex. 2020).

[6] 846 F. App'x 248 (5th Cir. 2021).

[7] *Id.* at 252.

[8] *See id.* at 249.

with respect to "any 'continuation, change or resumption' of property damage 'during or after the policy period' that was known 'prior to the policy period' 'in whole or in part.'"[9]

In "the summer of 2014," 5D was hired to drill a commercial irrigation well through the Edwards Aquifer.[10] 5D was later sued for breach of contract and negligence after it purportedly drilled the well with "unacceptable deviation" and then abandoned the well after it "stuck" the drill bit in the bore hole.[11] This allegedly rendered the "well practically useless for its intended/contracted for purpose."[12] 5D then purportedly "failed and refused to plug the well, retrieve the drill bit, and drill a new well."[13] 5D sought coverage for the lawsuit from both BITCO and Monroe. BITCO ultimately agreed to provide a defense, but Monroe refused, arguing that the "property damage" at issue did not occur during its policy period.[14] In fact, BITCO and Monroe stipulated that the drill bit was stuck in the bore hole "'during drilling' 'in or around November 2014.'"[15] BITCO subsequently filed a declaratory judgment action against Monroe and won summary judgment that Monroe owed a duty to defend.

On appeal to the Fifth Circuit, Monroe urged the court to consider the stipulation between it and BITCO regarding the date of the incident, even though that information was extrinsic evidence.[16] BITCO countered that Texas's "eight corners" rule prohibited consideration of such evidence, and that, even if that evidence was evaluated, it did not establish that Monroe had no duty to defend.[17] In beginning its analysis, the Fifth Circuit recognized that, while the Supreme Court of Texas had never adopted the *Northfield* Exception, it had "favorably cited" the *Northfield* Exception in prior cases.[18] Thus, according to the Fifth Circuit, whether Texas law would permit a court to consider the undisputed date of an incident as relevant to determine whether a duty to defend exists under the scope of the *Northfield* Exception "is important because ascertaining the date of an occurrence is a frequently encountered 'gap' in third party pleadings."[19]

The Fifth Circuit noted that the "omitted date" of when damage or injury occurred can be a "key question" as it relates to whether the insurer has a duty to defend its insured in an underlying suit.[20] The Fifth Circuit recognized that it and some Texas federal courts had previously allowed the use of extrinsic evidence in certain circumstances to clarify the date of an occurrence or specific

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[9] *Id*.

[10] *Id.*

[11] *Id*.

[12] *Id*.

[13] *Id.*

[14] *Id.*

[15] *Id.*

[16] *Id*. at 250.

[17] *Id.*

[18] *Id*. at 251 (citing *Richards v. State Farm Lloyds*, 597 S.W.3d 492, 496–97 (Tex. 2020); *GuideOne Elite Ins. Co. v. Fielder Rd. Baptist Church*, 197 S.W.3d 305, 308–09 (Tex. 2006)).

[19] *Id.*

[20] *Id.*

circumstances surrounding a loss.[21] The court further recognized that the two leading insurance treatise commentators have urged the allowance of extrinsic evidence in limited circumstances when evaluating the duty to defend.[22] As a result, the Fifth Circuit certified the above questions for a ruling from the Supreme Court of Texas.

Addressing those certified questions, the Supreme Court reiterated the basis for the "eight corners" rule that it had articulated in *Richards—i.e.*, it is not a judicial amendment to insurance policies, but it is a rule designed to enforce the parties' contractual agreement that recognizes that, in most duty to defend clauses, the only two relevant documents are the policy and the pleading when making an initial inquiry into whether the claimant's allegations fit within the coverage available.[23] Nevertheless, it is not a hard and fast rule, as the Court itself had adopted an exception in *Avalos* and other courts in Texas—both state and federal—had recognized that extrinsic evidence should be considered when a lawsuit could trigger the duty to defend but is silent on a coverage-determinative fact.[24]

Following the Court's jaunt down memory lane, it finally hit the issue squarely: "Today, we expressly approve the practice of considering extrinsic evidence in duty-to-defend cases to which *Avalos* does not apply."[25] The Court was clear that the "eight corners" rule was not being abandoned; rather, it remains the "initial inquiry" for determining whether a defense is owed. When that is insufficient, however, the Court provided the following guidance:

> [I]f the underlying petition states a claim that could trigger the duty to defend, and the application of the eight-corners rule, due to a gap in the plaintiff's pleading, is not determinative of whether coverage exists, Texas law permits consideration of extrinsic evidence provided the evidence (1) goes solely to an issue of coverage and does not overlap with the merits of liability, (2) does not contradict facts alleged in the pleading, and (3) conclusively establishes the coverage fact to be proved.[26]

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[21] *Id*. (citing *Ooida Risk Retention Grp., Inc. v. Williams*, 579 F.3d 469, 476 (5th Cir. 2009) (examining extrinsic evidence to establish tandem driving of a commercial motor vehicle and, thus, the application of an exclusion that precluded the insurer's duty to defend); *Primrose Oper. Co. v. Nat'l Am. Ins. Co.*, 382 F.3d 546, 550 (5th Cir. 2004) (relying on extrinsic evidence (parties' stipulation) to determine whether pollution spills occurred during policy in evaluating duty to defend); *Century Sur. Co. v. Dewey Bellows Oper. Co.*, No. H-08-1901, 2009 WL 2900769, at *8 (S.D. Tex. Sept. 2, 2009) (concluding an exclusion applied and no duty to defend existed after examining extrinsic evidence within a counterclaim); *Boss Mgmt. Serv., Inc. v. Acceptance Ins. Co.*, No. H-06-2397, 2007 WL 2752700, at *11–12 (S.D. Tex. Sept. 17, 2007) (considering "occupancy certificates" as extrinsic evidence in evaluating the earliest date in which damage could have appeared).

[22] *Id*. at 251–52 (citing COUCH ON INS. § 200:22 (3d ed. 2020); 1 NEW APPLEMAN INSURANCE LAW PRACTICE GUIDE 11A.13 (2020)).

[23] 640 S.W.3d 195, 199 (Tex. 2022).

[24] *Id.*

[25] *Id.* at 201.

[26] *Id.* at 201–02.

As the Court noted, its exception to the "eight corners" rule tracks the *Northfield* Exception but with "minor refinements."[27] The question of whether it is "initially impossible to discern whether coverage is *potentially* implicated" was replaced with a "better threshold inquiry" of "does the pleading contain the facts necessary to resolve the question of whether the claim is covered?"[28] And the types of extrinsic evidence that could be considered was not limited to evidence of a "fundamental" coverage issue like whether the person or property is insured or whether a policy exists. Instead, that limitation was eliminated altogether.[29] Third, the proffered evidence must conclusively establish the coverage fact at issue and cannot be considered if a genuine issue of material fact will remain to be proved.[30]

According to the Court, consideration of extrinsic evidence under such standards "advances our dual goals of effectuating the parties' agreement as written, while protecting the insured's interests in defending against the third party's claims."[31] "A contrary rule that ignores conclusively proven facts showing the absence of coverage would create a windfall for the insured, requiring coverage for which the insured neither bargained nor paid. Such a windfall would come at the expense of all consumers of insurance, who ultimately shoulder the expense of the insurer's increased defense costs through higher premiums."[32]

Turning to the facts before it and applying the new *Monroe* Exception, the Court found that the extrinsic evidence could not be used to negate the duty to defend. In that regard, although the Court agreed that extrinsic evidence of the date of an occurrence could be considered, the evidence proffered overlapped with the merits of liability.[33] More specifically, the Court explained as follows:

> In cases of continuing damage like the kind alleged here, evidence of the date of property damage overlaps with the merits. A dispute as to *when* property damage occurs also implicates *whether* property damage occurred on that date, forcing the insured to confess damages at a particular date to invoke coverage, when its position may very well be that no damage was sustained at all.[34]

Accordingly, while Monroe sought to use the stipulation to avoid an obligation to defend, the Court noted that the insured likely would have sought to establish that sticking of the drill bit did not cause *any* damage, but to obtain coverage in the face of its insurer's refusal, 5D would have had to argue that *some* damage occurred after the November 2014 date, undermining its liability defense. Accordingly, because Monroe's proposed use of the stipulation would overlap with the

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[27] *Id.* at 202.

[28] *Id.*

[29] *Id.* at 203.

[30] *Id.*

[31] *Id.*

[32] *Id.*

[33] *Id.* at 204.

[34] *Id.*

merits of the liability case, the Court held that it could not be considered for purposes of the duty to defend.[35]

C. *Pharr-San Juan-Alamo Independent School District v. Texas Political Subdivisions Property/Casualty Joint Self Insurance Fund*, 642 S.W.3d 466 (Tex. 2022)

Wasting no time, the Supreme Court analyzed whether the *Monroe* Exception was implicated in *Pharr-San Juan-Alamo Independent School District v. Texas Political Subdivisions Property/Casualty Joint Self Insurance Fund* ("*Pharr*").[36] In that case, the parties disputed whether an automobile liability insurance policy required an insurer to defend and indemnify the insured against claims for damages arising from an accident involving the negligent use of a "golf cart."[37] The policy applied only to liability that the insured had for damages caused by an accident and resulting from the use of a covered auto.[38] The insurer had refused to provide coverage, asserting that a "golf cart" was not an "auto" under the policy because a "golf cart" is not designed for travel on public roads.[39]

In evaluating the issue, the Supreme Court explained that it must first start—as outlined in *Monroe*—with whether the pleading states a claim that implicated the duty to defend.[40] The Supreme Court explained that it would evaluate the term "golf cart" in the context of its use within the pleading and consistent with its common, ordinary meaning.[41] In doing so, the Supreme Court ruled that a "golf cart" is not understood to be a "vehicle designed for travel on public roads," and, as such, the insuring agreement was not met to implicate the duty to defend.[42]

The Supreme Court refused to look to extrinsic evidence. Pursuant to the *Monroe* Exception, the extrinsic evidence only would be admissible to fill a "gap" in the pleading that otherwise would leave the court unable to determine whether coverage applied.[43] Because the pleading asserted that the injured person was thrown from a "golf cart," and because the Supreme Court determined that a "golf cart" is not a "vehicle designed for travel on public roads," there was no "gap" to prevent the Court from determining if the duty to defend was triggered. Further, the Court explained, "Mere disagreements about the common, ordinary meaning of an undefined term do not create the type of 'gap' *Monroe* requires. And in the absence of such a gap, any extrinsic evidence that [the injured person] was actually thrown from something other than a 'golf cart'

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[35] *Id.*

[36] 642 S.W.3d 466, 477 (Tex. 2022).

[37] *Id.* at 469.

[38] *Id*.

[39] *Id*.

[40] *Id*. at 473.

[41] *Id.*

[42] *Id*. at 475.

[43] *Id*. at 477.

would contradict the facts alleged in [the] petition."[44] The Court commented that, if the pleading had simply referred to a "vehicle" being involved, without any indication of the type of vehicle or whether it was designed for travel on public roads, that potentially would create the "gap" referenced in the *Monroe* Exception.

D. Commentary

Texas federal district courts and Texas state appellate courts have evaluated whether extrinsic evidence is admissible in determining the duty to defend in many cases over the years. Without guidance from the Supreme Court of Texas, this led to a number of inconsistent rulings. The adoption of the "collusive fraud" exception in *Avalos* was not a shock, especially given the facts and circumstances of the case. The very narrow exception to the "eight corners" rule carved out in that case requires conclusive proof of collusion and insurance fraud by the insured and the third-party claimant. Given the unwillingness of the Supreme Court of Texas to adopt the *Northfield* Exception despite being presented with (many) opportunities to do so, and the omission of any reference at all to the existence of the *Northfield* Exception in *Avalos*, a question existed as to whether the exception still was good law. Presumably, the Fifth Circuit also recognized this development, finally putting the question squarely in front of the Supreme Court of Texas for a definitive answer on the issue.

The Court's ruling in *Monroe*, while addressing *Northfield* directly, still leaves questions to be answered. In that regard, if a stipulation of fact was not enough to satisfy the exception, what will be enough? The answer may well be that stipulations *can* be enough, so long as what is stipulated truly is a "coverage only" fact. It is on that point that the bar can expect continued litigation.

Since February 2022, sixteen other Texas decisions cited to *Monroe*. One was not an insurance case at all. One court cited the case for a different proposition altogether.[45] Of the remaining fourteen decisions, five courts allowed the consideration of extrinsic evidence (one without objection by the parties), and the remainder noted that there was not extrinsic evidence at issue, or the extrinsic evidence did not meet the strict standards of *Monroe*.

For those courts that determined that the strict standards were not met, the reasoning generally was that no "gap" existed in the pleadings that needed to be filled by extrinsic evidence. That decision was reached by federal district courts in *Everest National Insurance Co. v. Megasand Enterprises, Inc.*,[46] *Allied Property & Casualty Insurance Co. v. Armadillo Distribution Enterprises, Inc.*,[47] and *Certain Underwriters at Lloyd's, London v. Keystone Development,*

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[44] *Id*.

[45] *Clear Blue Ins. Co. v. Fernandez*, Case No. 1:22-CV-00038-RP, 2023 WL 222239 (W.D. Tex. Jan. 17, 2023) ("The primary goal of contract construction is to effectuate the parties' intent as expressed in the contract." (citing *Monroe Guar. Ins. Co.*, 640 S.W.3d at 198–99)).

[46] Civ. A. No. 4:20-CV-1265, 2022 WL 6246854 (S.D. Tex. Aug. 5, 2022).

[47] Civ. A. No. 4:21-CV-00617-ALM, 2022 WL 3568482 (E.D. Tex. Aug. 18, 2022).

LLC.[48] A single court ruled that the evidence at issue conflicted with the merits of the underlying liability lawsuit in *Knife River Corp.-South v. Zurich American Insurance Co.*[49]

In the four cases that addressed extrinsic evidence substantively and allowed the evidence to be considered, one did so in the context of a claims-made policy and in determining whether a claim was "first made" during the policy (*Drawbridge Energy US Ventures, LLC v. Federal Insurance Co.*[50]), one did so to assess whether a party was an insured (*Benites v. Western World Insurance Co.*[51]), one did so for purposes of determining the identification of a truck at issue (*Progressive Commercial Casualty Insurance Co. v. Xpress Transport Logistics, LLC*[52]), and one did so in order to establish whether the accident at issue occurred in the "coverage territory" of the policy (*National Liability & Fire Insurance Co. v. Turimex, LLC*[53]).

Interestingly, in *Monroe*, the Supreme Court of Texas eschewed any notion that the consideration of extrinsic evidence should be limited to "fundamental" issues of coverage like insured status or whether the property at issue was insured. Yet, in practice, at least so far, that is exactly the types of cases in which extrinsic evidence actually has been allowed. Only time will tell whether that will continue to be the case, but one thing remains certain—the duty to defend is governed in most cases by the "eight corners" rule in Texas.

II. Loss During the Policy Period and "Continuation, Change or Resumption" Provision – An Update

Most liability insurance policies contain a provision that states that, if there is damage that begins during the policy period, coverage extends for any damage that continues, changes, or resumes after the expiration of the policy period. The United States District Court for the Southern District of Texas recently evaluated the meaning and scope of this language in a commercial excess policy.

A. *Colony Ins. Co. v. First Mercury Ins. Co.*, No. CV H-18-3429, 2020 WL 5658662 (S.D. Tex. Sept. 22, 2020).

In *Colony Insurance Co. v. First Mercury Insurance Co.*, the United States District Court for the Southern District of Texas evaluated the meaning and applicability of the "continuation, change or resumption" provision commonly found in liability insurance policies.[54] In that case, Cambridge Builders & Contractors, LLC ("Cambridge") contracted in 2012 to build an apartment complex for Archstone Memorial Heights Villages I LLC ("Archstone"). The final certificate of occupancy was issued on October 23, 2014. Cambridge had primary and excess insurance policies

[48] Civ. A. No. 3:21-CV-336-L, 2022 WL 6202129 (N.D. Tex. Oct. 7, 2022).

[49] Civ. A. No. 3:21-CV-1344-B, 2022 WL 686625 (N.D. Tex. Mar. 8, 2022).

[50] Civ. A. No. 4:20-CV-03570, 2022 WL 991989 (S.D. Tex. Apr. 1, 2022).

[51] Case No. 1:21-CV-1093-RP, 2022 WL 2820669 (W.D. Tex. July 18, 2022).

[52] Civ. A. No. H-21-2683, 2022 WL 6779078 (S.D. Tex. Oct. 11, 2022).

[53] Civ. A. No. 4:21-cv-3967, 2022 WL 16838038 (S.D. Tex. Oct. 20, 2022).

[54] No. CV H-18-3429, 2020 WL 5658662, at *7 (S.D. Tex. Sept. 22, 2020).

issued by First Mercury Insurance Company ("FMIC"), Colony Insurance Company ("Colony"), and Navigators Specialty Insurance Company ("Navigators") in effect during the time of construction, as follows:

Policy Period	Primary Insurer	Excess Insurer
2011 to 2012	FMIC	FMIC
2012 to 2013	FMIC	FMIC
2013 to 2014	Navigators	FMIC
2014 to 2015	Navigators	Colony

Each primary policy provided up to $1 million per occurrence, while each excess policy provided up to $10 million in coverage.[55]

Archstone sued Cambridge in 2015, asserting that construction defects caused water damage to the complex's sheathing, framing, patio decks, stair landings, stucco system, masonry, windows, and roof. The damages were alleged to have occurred over time, spanning the term of multiple insurance policies. Navigators and FMIC participated in Cambridge's defense as primary insurers.[56]

Archstone demanded $8.25 million to resolve all claims against Cambridge.[57] Cambridge's own expert witnesses calculated that Cambridge was liable for over $2.7 million in repair costs. FMIC and Navigators each paid $500,000 toward the settlement out of the primary insurance layer. Colony determined that an additional $2 million would need to be paid from the excess layer to settle the case. Colony therefore requested that FMIC contribute additional money to the settlement, as it had issued the excess policies that were in effect when the damage to the complex began.[58]

Colony did '"not necessarily agree"' with the damage calculation by Cambridge's experts but explained to FMIC's counsel that the evidence showed that both excess insurers were obligated to indemnify Cambridge.[59] According to the court, "Colony warned [FMIC] that if [Colony] was forced to fund a settlement without [FMIC's] participation, Colony would seek reimbursement in a separate lawsuit."[60] FMIC denied coverage and refused to contribute to the settlement, stating that it was not '"provided any evidence or quantifying of any covered damage in the policy's term."'[61] Colony ultimately paid $1,925,000 toward the settlement, while FMIC made no

[55] *Id*. at *1.

[56] *Id.*

[57] *Id*. at *2.

[58] *Id.*

[59] *Id.*

[60] *Id.*

[61] *Id.*

additional contribution. Colony then filed suit, seeking reimbursement from FMIC for FMIC's pro rata share of the settlement.

After first rejecting FMIC's argument that Colony's right of subrogation was abrogated by the decision of the Supreme Court of Texas in *Mid-Continent Insurance Co. v. Liberty Mutual Insurance Co.*,[62] the court then evaluated whether the FMIC policies were implicated by the loss.[63]

The court noted that FMIC's excess insurance policies were only triggered if the concurrent primary insurance policies were exhausted. The parties did not dispute that there was one "occurrence" in the underlying case: Cambridge's failure to ensure proper construction of the building.[64] FMIC argued, however, that Colony had not shown that the primary policies paid $1 million per occurrence to exhaust the primary layer. In evaluating this issue, the court explained that, because consecutive primary policies cover the loss, "when 'a single occurrence triggers more than one policy, covering different policy periods, . . . the insured's indemnity limit should be whatever limit applied at the single point in time during the coverage periods of the triggered policies when the insured's limit was highest.'"[65] This principle prohibits "stacking" policy limits to provide a loophole that would allow higher recovery for incidents lasting longer than one policy term. As such, '"[o]nce the applicable limit is identified, all insurers whose policies are triggered must allocate funding of the indemnity limit among themselves according to their subrogation rights."'[66]

Based on this, the court explained that "Colony, standing in the shoes of Cambridge, must (1) identify the highest limit of primary coverage and (2) show that this limit was paid by the insurer or insurers whose policies were triggered."[67] The parties agree that the highest limit of primary coverage that Cambridge contracted for was $1 million per occurrence. Because Colony showed that the $1 million primary limit was paid by a combination of the contribution of $500,000 by FMIC and Navigators, the court ruled that Colony met its burden to show that the primary layer was exhausted.

The next issue was whether there was damage during FMIC's policy period. Seeking to establish this, Colony produced emails from apartment complex personnel that describe leaks from a window, the roof, the night drop box, and an air conditioning unit between February of 2013 and October of 2014. The court concluded that, "[w]hile there [were] disputed fact questions as to how the damage occurred or when it began, these emails constitute some evidence that damage occurred during [FMIC's] excess policy period."[68]

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[62] *Id*. at *3 (citing *Mid-Continent Ins. Co. v. Liberty Mut. Ins. Co.*, 236 S.W.3d 765, 777 (Tex. 2007)).

[63] *Id*. at *5.

[64] *Id.*

[65] *Id.* (quoting N. *Am. Specialty Ins. Co. v. Royal Surplus Lines Ins. Co.*, 541 F.3d 552, 557 (5th Cir. 2008)).

[66] Id. (quoting *Am. Physicians Ins. Exch. v. Garcia*, 876 S.W.2d 842, 855 (Tex. 1994)).

[67] *Id*. at *6.

[68] *Id.*

FMIC asserted that, even if these emails showed losses during the 2013–2014 policy period, they did not show losses that exceeded $1 million.[69] According to the court, "[t]his is important because [FMIC's] excess policy is only triggered if covered losses exceed the $1 million limit of the primary layer."[70] In response, Colony pointed to the language in FMIC's policy that states an "'[i]njury or damage' which occurs during the Policy period . . . includes any continuation, change or resumption of that 'injury or damage' after the end of the Policy period."[71] Based on this language, the court explained that FMIC's "policy covers not only physical damage that occurred prior to November 7, 2014, but also any continuation of that damage that occurred after November 7, 2014."[72] Thus, the court found that "[t]he monetary requirement for coverage is therefore not restricted to physical damage that occurred during the 2013–14 policy term."[73] Instead, to show losses that exceed $1 million, the court found that "Colony may add together both the amount of any damage that occurred during the 2013–14 policy *plus* the amount of any loss that occurred after November 7, 2014, if the later damage extended from the 2013–14 damage and was caused by the same single occurrence."[74]

The court found that reports were produced that FMIC was on notice that experts found damage in 2016 and 2017 that could support a continuation or resumption of the damage reported during FMIC's 2013–2014 policy period:

> For example, experts opined that leaks through the night drop box, roof, air conditioner, windows, and drains caused stains, decay, cracks, and water damage . . . . Because the leaks came from the same places and resulted in the same types of damage as reported in the 2013–14 emails, these documents are enough to create a fact question as to how the damage occurred or when it began, which should be decided at trial. [citation omitted]. Colony has presented evidence that a fact issue exists as to coverage under [FMIC's] excess policies.[75]

As a result of the court's decision on summary judgment, the case proceeded to a bench trial in February 2022. In September 2022, the court issued findings of fact and conclusions of law, determining that Colony failed to establish at trial that damage occurred during FMIC's policy period.[76] First, the court noted that FMIC changed its position just before trial and argued that endorsements actually removed the "continuation, change, or resumption" language from its policies.[77] The court noted that had evidence of such change been presented on summary judgment,

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[69] *Id*. at *7.

[70] *Id.*

[71] *Id.*

[72] *Id.*

[73] *Id.*

[74] *Id*. (emphasis added).

[75] *Id.*

[76] *Colony Ins. Co. v. First Mercury Ins. Co.*, No. 4:18-CV-03429 (S.D. Tex. Sept. 26, 2022) (Doc. 137 – Findings of Fact and Conclusions of Law).

[77] *Id.*, slip op. at 6.

it may well have changed the outcome on summary judgment.[78] Second, the court noted that Colony did not present the aforementioned emails in admissible form at trial, which the court had relied on in finding a genuine issue of material fact as to whether damage occurred during FMIC's policy period.[79] Had the court known that such evidence would not be presented at trial, "the outcome on summary judgment might very well have been different."[80] Ultimately, the court determined that "Colony has failed to show by a preponderance of the evidence that any property damage caused by Cambridge's faulty construction took place during First Mercury's excess policy periods" or that "First Mercury had any duty to indemnify Cambridge."[81] Simply put, Colony had not right of recovery against FMIC for the monies it paid in settlement of the claims against their mutual insured.

B. Commentary

Many insurers seem to overlook or simply ignore the "continuation, change or resumption" language in the insuring agreement. Rather, insurers sometimes will entrench themselves in a position that they are only going to provide indemnity coverage for damage that occurred during its policy period. While it is true that, to trigger *defense* coverage under a commercial liability policy, the actual injury must be alleged to have occurred during the policy period. The total amount of *indemnity* coverage for that damage, however, must be evaluated in light of any continuation, change, or resumption that goes beyond the policy period. Of course, if that policy language does not actually exist, the result may well be completely different. And if that language is included, the party with the burden still will have to offer proof of damage during the relevant time frame. As the use of the "continuation, change, or resumption" language remains commonplace, we may well see this issue before a Texas court in the near future.

III. Number of "Occurrences"

An ongoing dispute exists in the world of general liability insurance as to how to count the number of "occurrences" that exist in a given case. While courts appear to be in universal agreement in Texas that the "cause" test (rather than the "effects" test) is the correct test for determining the number of "occurrences," its application has been less than consistent. In the past year, two courts addressed the issue squarely—both in the context of faulty workmanship disputes.

A. *Urban Oaks Builders LLC v. Gemini Insurance Co.*, Civ. A. No. 4:19-CV-4211, 2021 WL 7209213 (S.D. Tex. Dec. 14, 2021), *adopted by*, 2022 WL 605575 (S.D. Tex. Feb. 28, 2022)

At the end of 2021, Magistrate Judge Christina Bryan of the Southern District of Texas issued a report and recommendation on the "number of occurrences" issue that ultimately was

[78] *Id.*

[79] *Id.*, slip op. at 6–7.

[80] *Id.*, slip op. at 7.

[81] *Id.*

adopted, in full, by District Judge Charles Eskridge.[82] The case involved the construction of a project including six apartment buildings and a clubhouse in Florida by Urban Oaks Builders ("UOB"). UOB retained subcontractors to perform work on the project, and all the contractors were enrolled under a contractor-controlled insurance program, which included a policy issued by Gemini Insurance Company ("Gemini"). Ironshore Specialty Insurance Company ("Ironshore") issued an excess policy above the primary insurance policy issued by Gemini.[83]

Following completion of the project and its ultimate sale to Southstar Capital Group I, LLC ("Southstar"), the new purchaser asserted claims against UOB for allegedly defective construction.[84] The parties entered into an agreement for UOB to perform certain warranty work, and UOB made a claim on the Gemini policy for that work. Gemini made two payments totaling approximately $1.1 million. Later, Southstar and UOB entered into a "Standstill Agreement" under which UOB agreed to pay about $2 million, which was to be credited against any future judgment if Southstar prevailed in litigation). Subsequently, Gemini made a final payment of about $900,000 (for a total of $2 million—its "per occurrence" limit of insurance) to UOB.[85]

Southstar filed suit in Florida and UOB sought a defense from its insurers. Gemini, having paid its $2 million limit of insurance, declared that its policy had been exhausted and refused to provide a defense.[86] UOB ended up in bankruptcy in Texas and initiated a lawsuit against the insurers for coverage in Florida. When the latter case became the subject of a jurisdictional dispute, UOB dismissed it and refiled its claim as an adversary proceeding in the bankruptcy court. Ultimately, though, it was withdrawn from the bankruptcy court and proceeded in District Court.[87] The heart of the dispute was "whether Plaintiffs' claims for defense and indemnity under the Policies involve a single occurrence or multiple occurrences as defined in the Gemini Policy."[88]

After noting the applicability of the "eight corners" rule for determining the duty to defend, the court turned its focus to the "cause" test and the determination of the number of occurrences at issue in Southstar's claim against UOB.[89] Magistrate Judge Bryan noted that the Fifth Circuit had thoroughly explained how to determine whether a single or multiple occurrences exist:

> [T]he appropriate inquiry is whether there was one proximate, uninterrupted, and continuing cause which resulted in all of the injuries and damage. If so, then there was a single occurrence. If the chain of proximate causation was broken by a pause in the negligent conduct or by some intervening cause, then there were multiple occurrences, even if the

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[82] *Urban Oaks Bldrs. LLC v. Gemini Ins. Co.*, Civ. A. No. 4:19-CV-4211, 2021 WL 7209213 (S.D. Tex. Dec. 14, 2021), *adopted by*, 2022 WL 605575 (S.D. Tex. Feb. 28, 2022).

[83] 2021 WL 7209213, at *1.

[84] *Id.* at *2.

[85] *Id.*

[86] *Id.*

[87] *Id.*

[88] *Id.*

[89] *Id.* at *3.

> insured's negligent conduct which caused each of the injuries was the same kind of negligent conduct.[90]

Importantly, the court noted that the Fifth Circuit clarified in *Evanston* that its prior decision in *H.E. Butt Grocery Co. v. National Union Fire Insurance Co. of Pittsburgh, Pa.* "does not stand for the proposition that a single overarching cause can *never* constitute a single occurrence under an insurance policy."[91] "Texas law only prohibits courts from looking to the 'overarching cause' of the injuries when the overarching cause is not a 'proximate, uninterrupted, and continuing cause' of all the injuries."[92] "In other words, unless the proximate cause for the injuries is continuous and unbroken, there must be more than one occurrence."[93]

Turning to the facts before the court, Magistrate Judge Bryan pointed out that at least one excess insurer claimed that no party disputed that the claims at issue involved "multiple construction defects, at multiple locations [or at multiple buildings], constructed at different points of time, and attributable to the construction activities of multiple subcontractors, each performing different activities within, and among, the separately constructed buildings."[94] In fact, the insured even argued that there were at least five different occurrences. Gemini, on the other hand, claimed that only a single occurrence existed because the sale of the property to Southstar was the single occurrence by which UOB became liable to Southstar.[95]

Ultimately, the court disagreed with Gemini and found that multiple occurrences existed. The court found support in both *U.E. Texas One-Barrington, Ltd. v. General Star Indemnity Co.* and *Lennar Corp. v. Great American Insurance Co.*[96] With regard to *U.E. Texas One*, the court in that case addressed plumbing leaks under nineteen different buildings and found that nineteen different occurrences existed for purposes of coverage under a first-party property insurance policy. The Fifth Circuit in that case rejected a single occurrence position, noting that "'Texas One's property experienced multiple leaks distinguishable in space and time' and each leak was responsible for damage to a separate building."[97] The *Urban Oaks* court made the following observation of that decision: "Importantly, the majority opinion rejected the argument made by the dissent that courts apply a 'liability triggering test' under policies designed to protect the insured from liability to others (liability policies) as opposed to policies designed to protect the insured from damage or loss to property owned by the insured (loss policies)."[98] Gemini's single occurrence position was premised on the sale event that triggered liability to Southstar rather than the cause of the damages at issue, which were the various acts of faulty construction. Because the

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[90] *Id.* at *4 (quoting *Evanston Ins. Co. v. Mid-Continent Cas. Co.*, 909 F.3d 143, 148–50 (5th Cir. 2018)).

[91] *Id.* (citing *Evanston Ins. Co.*, 909 F.3d at 150 (discussing *H.E. Butt Grocery Co.*, 150 F.3d 526 (5th Cir. 1998))).

[92] *Id.* (quoting *Evanston Ins. Co.*, 909 F.3d at 151 (citing *H.E. Butt Grocery Co.*, 150 F.3d at 534)).

[93] *Id.* (quoting *Evanston Ins. Co.*, 909 F.3d at 148).

[94] *Id.*

[95] *Id.*

[96] *Id.* at *5.

[97] *Id.* (citing *U.E. Tex. One*, 332 F.3d 274, 278 & n.3 (5th Cir. 2003)).

[98] *Id.* (citing *U.E. Tex. One*, 332 F.3d at 277 n.2).

damages did not arise from a "single, uninterrupted, continuing cause," there were multiple occurrences.[99] And, with respect to *Lennar Corp.*, the court noted that, in that case, Lennar was liable to multiple homeowners for its installation of EIFS on multiple homes but each installation of EIFS only damaged a particular home, constituting a separate occurrence with respect to each.[100] Similarly, in the case before it, Southstar's alleged damages were the result of multiple contractors causing multiple types of construction defects in multiple buildings, which constituted multiple occurrences.[101]

Importantly, Magistrate Judge Bryan rejected Gemini's reliance on two, unpublished Northern District of Texas decisions to support its single occurrence requirement. The court noted that the first pre-dated the Fifth Circuit's decision in *Evanston Insurance* and represented an application of the "liability triggering event" test (the sale of a property) instead of looking at the cause of the injuries insured against.[102] The case only involved the developer instead of the developer (who sold the project here) and the contractor (who built it), but whose losses arose from claims of negligent construction. Accordingly, the court refused to follow it.[103] As to the second, *Liberty Insurance Underwriters v. First Mercury Insurance Co.*, Magistrate Judge Bryan found it to be too conclusory to support a single occurrence under the instant facts. In particular, the district court in that case purported to apply the "cause test," finding that, although there multiple construction defects leading to different types of damage, all the damage was caused by a single event at a single facility—*i.e.*, the performing arts center on which the defective construction of the contractor and its subcontractors purportedly was performed.[104] According to the *Urban Oaks* court, "This Court finds the analysis in the *Liberty* opinion too conclusory to provide much guidance. In light of the various construction defects that led to different types of property damage, it is difficult to reconcile the *Liberty* court's finding of a single overarching cause of damage with Fifth Circuit precedents."[105]

While the court found that multiple occurrences existed, it did not opine on the *number* of occurrences that actually took place, noting that a determination of the number was not necessary. In that regard, because the court confirmed that there were multiple occurrences and the parties conceded that, if there were multiple occurrences, the limits of the Gemini policy had not been exhausted and Gemini's duty to defend had not been terminated.[106]

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[99] *Id.*

[100] *Id.* (citing *Lennar Corp.*, 200 S.W.3d 651, 682 (Tex. App.—Houston [14th Dist.] 2006, pet. denied), *abrogated on other grounds by Gilbert Tex. Constr., L.P. v. Underwriters at Lloyd's, London*, 327 S.W.3d 118 (Tex. 2010)).

[101] *Id.*

[102] *Id.* at *6 (discussing *Trammell Crow Residential Co. v. St. Paul Fire & Marine Ins. Co.*, No. 3:11-CV-2853-N, 2014 WL 12577393, at *4–*5 (N.D. Tex. Jan. 21, 2014)).

[103] *Id.*

[104] *Id.*

[105] *Id.*

[106] *Id.* at *8.

B. *Millsap Waterproofing, Inc. v. United States Fire Insurance Co.*, Civ. A. No. 3:20-CV-00240, 2022 WL 1594341 (S.D. Tex. May 19, 2022)

Just months after Judge Eskridge adopted Magistrate Judge Bryan's report and recommendation in *Urban Oaks*, Magistrate Judge Andrew Edison issued an opinion on the "number of occurrences" question in *Millsap Waterproofing, Inc. v. United States Fire Insurance Co.*[107] In that case, Millsap Waterproofing had been retained to perform various types of waterproofing work on a fire-damaged condominium project in Galveston that originally had been under repair following damage from Hurricane Harvey.[108] Other contractors also performed work on the repairs, and eventually problems arose with the work that was performed, leading to a lawsuit brought by the condominium association and into which more than eighty homeowners intervened. Relevant to the issues for Millsap Waterproofing, "the state-court plaintiffs alleged that Millsap negligently performed work on windows, doorways, walkways, and balconies, resulting in extensive water damage to the condominium's common areas (*e.g.*, walkways) and individual condominium units."[109]

Millsap had primary general liability coverage with Amerisure Insurance Company in the amount of $1 million per occurrence and $2 million in the aggregate. Excess of that coverage, United States Fire Insurance Company issued a $5 million limit policy.[110] Millsap provided timely notice of the lawsuit to the insurers, and Amerisure paid for the defense. When Amerisure determined that the claims could not settle for $1 million or less, it refused to pay any more than its single occurrence limit. U.S. Fire, on the other hand, denied coverage outright, claiming that it had no obligation until Amerisure paid $2 million because there were multiple occurrences. Millsap ultimately accepted Amerisure's $1 million tender and paid $550,000 of its own money to resolve the liability lawsuit, then it sued its insurers to recover its payment.[111] In the coverage litigation, Millsap sought a ruling on the number of occurrences (without advocating a position) so that the correct insurer could reimburse Millsap for its settlement payment. Not surprisingly, the insurers staked out opposite positions of one another as to whether there was a single occurrence (Amerisure) or multiple occurrences (U.S. Fire).[112]

After reviewing Texas law on the "number of occurrences" issue, including discussion of *Evanston Insurance Co. v. Mid-Continent Insurance Co.*,[113] the court made clear that its review would be to determine "whether there was one proximate, uninterrupted, and continuing cause which resulted in all the injuries and damage. If so, then there was a single occurrence. If the chain of proximate causation was broken by a pause in the negligent conduct or by some intervening

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[107] Civ. A. No. 3:20-CV-00240, 2022 WL 1594341 (S.D. Tex. May 19, 2022).

[108] *Id.* at *1.

[109] *Id.*

[110] *Id.* (The excess policy initially had limits of $11 million but was later reduced to $5 million.)

[111] *Id.* at *2.

[112] *Id.*

[113] *Id.* at *3–*4 (citing, among others, *Evanston Ins. Co.*, 909 F.3d at 147).

cause, then there were multiple occurrences, even if the insured' negligent conduct which caused each of the injuries was the same kind of negligent conduct."[114]

Like in *Urban Oaks*, the court in *Millsap Waterproofing* followed the holding of *U.E. Texas One* and found multiple occurrences existed. In that regard, the court noted that the injury-causing events were distinguishable in space *and* time and, moreover, the events did not cause one another.[115] The court cited the same footnote of the decision in *U.E. Texas One* about the majority rejecting the dissent's contention that a "liability triggering event" test should be employed.[116] The court noted that Amerisure's argument for a single occurrence ignored the fact that the claims against Millsap were not the result of a single, uninterrupted, continuing cause of damage but rather from different types of work on multiple areas of separate buildings.[117] That damage occurred over the course of ten months and affected individual units and common areas.[118] While the court acknowledged that Millsap's poor workmanship was the root cause of the damage, to attribute the damage to that would be akin to tracing the damages caused by various leaks in *U.E. Texas One* to the installation of the plumbing system itself.[119] The court explained further:

> It cannot be said that the complained-of damages were the result of the "continuous or repeated exposure to substantially the same general harmful conditions." Dkt. 19-12 at 104 (defining "occurrence" in the Amerisure Policy). Nor can it be said that Millsap's work was a continuous and unbroken force that, once set in motion, caused multiple injuries. *See Evanston*, 909 F.3d at 148 ("unless the proximate cause for the injuries is continuous and unbroken, there must be more than one occurrence").[120]

By way of example, the court noted that Millsap's alleged failure to properly slope concrete decks was unrelated to its negligently performed waterproofing work, which caused the damage about which the individual owners complained even though their concrete decks were properly sloped.[121]

Notably, the court also rejected Amerisure's contention that the fact that Millsap worked under a single contract should affect the outcome. Amerisure's position was an attempt to distinguish *Lennar Corp.* where the sale of each individual home led to incurring liability to each

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[114] *Id.* at *4

[115] *Id.* at *5

[116] *Id.* (citing *U.E. Tex. One*, 332 F.3d at 277 n.2).

[117] *Id.*

[118] *Id.*

[119] *Id.* at *6.

[120] *Id.*

[121] *Id.*

individual homeowner.[122] Magistrate Judge Edison specifically noted that Magistrate Judge Bryan had just recently rejected a nearly identical argument in *Urban Oaks*.[123]

In sum, the court noted that "[t]he law is clear: I am to look at the number of different events that caused the complained-of damages, not whether Millsap's 'liability in the [state-court lawsuit] arose from the execution of one construction contract.'"[124] "Here, there is no one proximate, uninterrupted, and continuing cause that resulted in all the damages for which Millsap is responsible."[125] Simply put, "Millsap's negligent workmanship during any phase, standing alone, was a separate occurrence-causing force giving rise to liability to one or more state-court plaintiffs."[126] Thus, the judge recommended that Millsap's motion for partial summary judgment be granted to the extent it requested a finding that more than one "occurrence" was at issue in the state-court lawsuit.

C. Commentary on *Urban Oaks* and *Millsap Waterproofing*

As noted above, whether a construction defect lawsuit constitutes one or more occurrences under general liability policies has been an ongoing dispute for years. The fact that these courts have relied heavily on the decision in *U.E. Texas One*—a first-party property insurance case—to reach a conclusion of multiple occurrences certainly is interesting but not surprising when one follows the history of the issue. Over time, courts have routinely relied on that case in discussing liability insurance policies. Generally speaking, though, courts have been reluctant to apply first-party insurance principles to third-party liability policies. Nevertheless, here, the Southern District of Texas appears to have taken a somewhat unified stand (although *Millsap Waterproofing* remains pending, as the parties have filed objections to the report and recommendation, and no final decision has been rendered by the District Court). Should that reasoning take hold across Texas, primary insurers are going to be far more likely to owe their aggregate limits of insurance in construction defect litigation, potentially resulting in increased premiums for insureds across the industry.

IV. Evaluating the Duty to Defend in Construction Defect Cases

In the spring of 2022, the Western District of Texas addressed a common refrain—an insurer disputing its obligation to provide a defense to its insured under commercial general liability insurance policies. The court, in *Amerisure Mutual Insurance Co. v. McMillin Texas Homes*, disagreed with the insurer's contentions, noting that the insurer had ignored the distinctions between the duty to defend and the duty to indemnify, as well as disregarded "the rules of construction favoring the insured." Then, in the summer, the same court (but a different judge) addressed a similar issue. In that case, *Mid-Continent Casualty Co. v. JTH Custom Homes, Inc.*,

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[122] *Id.* at *7.

[123] *Id.* (discussing *Urban Oaks*, 2021 WL 7209213, at *5).

[124] *Id.* at *8.

[125] *Id.*

[126] *Id.*

the magistrate judge recommended that the district court judge deny Mid-Continent's motion for summary judgment on the duty to defend.

A. *Amerisure Mutual Insurance Co. v. McMillin Texas Homes*, Case No. SA-CV-01332-XR, 2022 WL 686727 (W.D. Tex. Mar. 8, 2022)

In *McMillin Custom Homes*, the insured sought defense from Amerisure under nine different commercial general liability insurance policies for a number of construction defect claims, which were presented as claims under the Residential Construction Liability Act (the "RCLA"), in arbitration, or in traditional lawsuits.[127] Amerisure filed suit, seeking a declaratory judgment that it did not have a duty to defend or indemnify McMillin.[128] McMillin filed a counterclaim for breach of contract with respect to the duty to defend.[129] Amerisure based its position on four key issues: (1) no allegations of "property damage," only faulty work; (2) exclusions j.(5), j.(6), k., and l. applied to negate coverage, (3) some of the policies contained exclusions for damage in the "products-completed operations hazard," and (4) "the costs of removing the allegedly defective exterior finish and repairing ancillary damage are not 'potentially covered claims.'"[130]

After discussing the summary judgment standard and the rules of interpretation of insurance policies, the court noted that Amerisure contended that the case boils down to a simple principle, a CGL policy is not a performance bond and, therefore, Amerisure did not have a duty to defend claims arising out of McMillin's faulty workmanship on the stucco exterior of the homes at issue. Noting that the Supreme Court of Texas rejected that very argument in *Lamar Homes, Inc. v. Mid-Continent Casualty Co.*, the court turned to the broader merits of Amerisure's contentions.[131]

1. "Property Damage"

On the issue of "property damage," aside from a single case against McMillin, Amerisure argued that the various homeowners did not allege that the defective stucco caused any "physical change to tangible property." According to Amerisure, the issue really is that the stucco did not meet applicable building codes.[132] Calling Amerisure's claims "patently false," the district court referenced explicit claims of damage to property beyond the stucco itself:

- As a direct and proximate result of the construction defects and violations, **the Home has suffered damages** not only to the exterior stucco, but also **to the underlying wire**

[127] 2022 WL 686727, at *1 (listing the claims by category and collecting the key allegations).

[128] *Id.* at *2.

[129] *Id.*

[130] *Id.* at *4.

[131] *Id.* at *6 ("Any similarities between CGL insurance and a performance bond . . . are irrelevant, however. The CGL policy covers what it covers. No rule of construction operates to eliminate coverage simply because similar protection may be available through another insurance product." (quoting *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 242 S.W.3d 1, 10 (Tex. 2007))).

[132] *Id.* at *7.

lath, paper backing, house wrap, flashing, water resistive barriers, sheathing, interior walls, interior floors and/or other property.

- "Plaintiff[s] now seek[s] recovery herein for damages proximately caused by the improper design and/or construction of the Home, **which has resulted in numerous defects and deficiencies in the various systems and components in the Home**, including violations of local and state building codes."[133]

Amerisure argued that such allegations utilized "stock phrases" like "damage to property" that should be disregarded as "vague and conclusory" and "artful pleading," but the court disagreed. In doing so, the court noted that Amerisure's position was "flawed." First, the insurer ignored the distinction between first- and third-party claims, where the duty to defend is "construed more broadly than any other insurance claim."[134] Moreover, "artful pleading" absent collusion to create a duty to defend is no exception to the "eight corners" rule.[135] According to the court: "Absent collusion with the insured, a third-party claimant has nothing to gain from invoking the insurer's duty to defend—the third-party claimant is as likely to recover from the insured as from the insurer. A first-party claimant, on the other hand, has a clear incentive to artfully plead claims such that they fall within the scope of the policy's coverage—if the claims are not covered, the claimant will not recover at all."[136]

Second, Amerisure's attempt to ignore the so-called "stock phrases" was in direct violation of Texas law, "which requires courts to construe both the terms of the policy and the factual allegations in the complaint liberally in favor of coverage, especially in the context of assessing the insurer's duty to defend."[137] In that same vein, the court criticized Amerisure's attempt to narrowly construe phrases involving diminished property value and code violations by contending that neither are "property damage." As the court explained, "Where, as here, the underlying complaints allege additional property damage, Amerisure's citations to individual allegations that might not invoke its duty to defend independently amount to misplaced efforts seeking to turn the eight-corners rule on its head."[138]

Third, and finally, the court pointed out that Amerisure's claims of insufficiency with respect to the allegations of "property damage" were based on case law interpreting the duty to indemnify.[139] In *Lennar Corp.*, the insured sought indemnification for settlements it already had paid, so by the time it sued its insurer, the extent of the damage at issue and the repairs necessary for that damage already were known because the repairs already had occurred.[140] In other words,

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[133] *Id.* (footnote citations omitted).

[134] *Id.* (quoting *Lamar Homes*, 242 S.W.3d at 29).

[135] *Id.* (citing *Liberty Surplus Ins. Co. v. Allied Waste Sys., Inc.*, 758 F. Supp. 2d 414, 420 (S.D. Tex. 2010)).

[136] *Id.*

[137] *Id.* at *8 (citations omitted).

[138] *Id.*

[139] *Id.* (citing *Lennar Corp. v. Great Am. Ins. Co.*, 200 S.W.3d 651, 677 (Tex. App.—Houston [14th Dist.] 2006, pet. denied)).

[140] *Id.* at *9.

the case was based on actual evidence sufficient for the duty to indemnify rather than "mere allegations" that govern the duty to defend.[141] The court again noted the Texas rule of construing allegations in favor of coverage at the duty to defend stage.[142]

The court summarized its analysis of the "property damage" issue succinctly, characterizing Amerisure's arguments as an attempt to utilize ambiguities in the allegations as reasons to deny coverage instead of the opposite, as required by Texas law. Thus, the court held that the allegations of "property damage" in the underlying complaints were sufficient to invoke the duty to defend.

2. The Exclusions

With respect to exclusions j.(5) and j.(6), the district court first noted that the two exlusions are limited by the phrase "that particular part." As the Fifth Circuit previously had explained, that "limitation precludes application of the exclusions to damage on other parts of the home or non-defective portions of the insured's work."[143] Notwithstanding that limitation, Amerisure argued that the exclusions applied because, with the exception of a single case, none of the claimants alleged any damage to any parts of the homes other than their stucco systems.[144] But the court noted that the term "system" necessarily involves multiple "parts," and, at the pleading stage, it was not clear which parts were the subject of allegedly defective work and which were not. Moreover, as a practical matter, some of the homeowners actually alleged damage to parts of their houses beyond the stucco system, including interior walls and floors, as well as other property.[145] Again, construing the allegations in favor of coverage, the court found the exclusions did not apply to negate the duty to defend.[146]

Turning to exclusion k., the "Damage to Your Product" exclusion, the court made short work of Amerisure's claim that it applied. In that regard, the court noted that the definition of "your product"—*i.e.*, "[a]ny goods or products, other than real property, manufactured, sold, handled, distributed or disposed of by: (a) You . . . ."—has been held by Texas courts to not apply to real property.[147] As such, the exclusion did not apply to the homes at issue in the complaints made against McMillin.

The court also addressed exclusion l., the "Damage to Your Work" exclusion. The version in the Amerisure policies removed the so-called "subcontractor exception" such that no exception to the exclusion existed if the damage was to McMillin's work. The court rejected Amerisure's

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[141] *Id.*

[142] *Id.*

[143] *Id.*

[144] *Id.* at *10.

[145] *Id.*

[146] *Id.*

[147] *Id.* (citing *CU Lloyd's of Tex. v. Main Street Homes, Inc.*, 79 S.W.3d 687, 697 (Tex. App.—Austin 2002, no pet.) (Exclusion K does not apply to "the construction of [a] building because in ordinary language buildings are constructed or erected, not manufactured and because any ambiguity in the policy language must be construed against the insurer and in favor of the insured.")).

argument, though, finding that Amerisure ignored the fact that the exclusion also requires that the damage at issue be to the insured's "completed" work.[148] In that regard, the court pointed out that the underlying complains did not allege *when* the damage at issue occurred. Accordingly, the damage could have occurred before, during, or after completion of the work. Had Amerisure wanted to exclude coverage for damage to the insured's work whether such damage occurred during operations or after they were completed, Amerisure could have done so but did not.[149] Instead, the policy makes a clear distinction between exclusions for damage to completed work—defective or not—and those for damage to ongoing operations, which are limited to "that particular part" of property damaged because of the insured's defective work.[150] The court distinguished the case law cited by Amerisure in support of its argument, ultimately concluding that, "[c]onstruing the allegations liberally in favor of McMillin, . . . Exclusion L does not excuse Amerisure of its duty to defend McMillin against the homeowners' claims because the property damage arising from McMillin's defective work could have occurred *before* completion of work on the homes."[151] For similar reasons, the court also rejected any application of the "completed operations" exclusion found in three of the policies issued by Amerisure.[152]

The court closed its discussion of exclusions by discussion exclusion j.(1), which had been raised by Amerisure for the first time in its reply brief. That exclusion barred coverage for damage to property McMillin owned, rented, or occupied.[153] "This argument relies on the factual allegation in the underlying complaints that McMillin sold the homes to the plaintiffs, which leads to the 'reasonable inference' that McMillin must have owned them in order to sell them."[154] After noting that an argument cannot be raised for the first time in a reply brief and, more importantly, that an argument that is not in the insurer's live pleading could not be a basis for summary judgment, the court addressed the merits of the exclusion.[155] In particular, Amerisure argued that, if as argued by McMillin the possibility exists that damage occurred before completion of the homes, then they occurred while operations were ongoing and when McMillin owned the homes (because McMillin had to have owned the homes in order to sell them). The pleadings, however, included no such allegations and, while Amerisure's position was not unreasonable, the court refused "to make any assumption about the ownership of the homes during construction, especially in light of the ever-increasing complexity of construction and real estate transactions."[156] Because the complaints were not sufficiently clear that McMillin owned the homes when they were damaged, the exclusion did not apply to negate the duty to defend.

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[148] *Id.*

[149] *Id.* at *11.

[150] *Id.*

[151] *Id.* at *12.

[152] *Id.*

[153] *Id.*

[154] *Id.*

[155] *Id.* at *13.

[156] *Id.*

3. "Rip and Tear" Coverage

The final substantive issue addressed by the district court was whether coverage existed for so-called "rip and tear" costs. In particular, "Amerisure asserts that the Policies do not cover tear-out work performed to remove and replace the stucco system because defective work itself does not constitute covered 'property damage' and any ensuing tear-out work would not qualify for independent coverage under the Policies."[157] The court noted, however, that Amerisure's argument was premised on the same alleged deficiencies associated with the allegations of "property damage" and the applicability of various exclusions, and, as such, they were based on the "same faulty reasoning advanced in Amerisure's earlier arguments."[158] At bottom, the court already had determined that there were sufficient allegations of "property damage" beyond the defective stucco work itself to invoke the duty to defend and none of the exclusions negated that obligation. And, in any event, as it had done previously, Amerisure relied on a case involving the duty to indemnify but, at the duty to defend stage, the insured did not have to demonstrate that the "rip and tear" work would be necessary. Rather, as not all "rip and tear" work is excluded from coverage under the standard form, "[t]he extent of any property damage and whether repair or removal of the stucco exterior is necessary to fix any covered damages will depend upon the facts in each instance."[159] Under the "eight corners" rule, on the other hand, the factual allegations were sufficient to allege a potentially covered claim for "rip and tear" costs, invoking the insurer's duty to defend.[160]

B. Commentary

The district court's decision in *McMillin Custom Homes* is another lesson on the favorability for the insured of interpreting the duty to defend. The primary takeaway is the reminder (again) that all inferences must be read in favor of coverage (and, thus, the duty to defend the insured). While Amerisure sought to rely on allegedly "vague and conclusory" allegations as a means to *avoid* its defense obligation, such allegations had to be construed the other way and in favor of coverage. While not a landmark decision by any means, it serves as yet another example of basic principles of Texas insurance law (just as the Fifth Circuit's decision in *Siplast, Inc. v. Employers Mutual Casualty Co.*,[161] was such an example in last year's paper).

C. *Mid-Continent Casualty Co. v. JTH Custom Homes, Inc.*, Case No. 1:21-cv-00520-LY, 2022 WL 2441855 (W.D. Tex. July 4, 2022), *adopted by* 2022 WL 17732682 (W.D. Tex. Sept. 6, 2022)

On July 4, 2022, Magistrate Judge Susan Hightower recommended to District Judge Lee Yeakel that Mid-Continent not secure its independence from its insured in a duty to defend dispute

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[157] *Id.* at *14.

[158] *Id.*

[159] *Id.*

[160] *Id.*

[161] 23 F.4th 486 (5th Cir. 2022).

involving allegations of defective construction of a custom home.[162] Two months later, Judge Yeakel agreed with that recommendation, holding that a duty to defend existed.

In *JTH Custom Homes*, the underlying plaintiffs allege that the insureds (the home building company and its owner) served as the general contractor for the construction of their home. After the home was not completed on time, the underlying plaintiffs moved in only to soon experience construction problems on the property, including "mold, electrical issues, drainage and masonry issues, and other defects with the windows, doors, swimming and entry pools, and fountain," all of which were attributed, at least in part, to the insureds' failure to supervise its employees and subcontractors (some of which also were named defendants in the lawsuit).[163] The insureds sought coverage from their general liability insurer, Mid-Continent, who agreed to defend under a reservation of rights and then filed a declaratory judgment action on both the duty to defend and the duty to indemnify.[164]

After addressing a motion to stay and a motion to strike, the court turned to the merits of Mid-Continent's position—no duty to defend existed because the claims in the underlying lawsuit arose only from defective work, which were barred by the defective work exclusions in the Mid-Continent policies.[165] In the alternative, Mid-Continent claimed "that the property damage exclusions apply and bar coverage for property damage to any part of the Property because JTH was the general contractor working on the entire property."[166] Ultimately, as explained below, the court rejected Mid-Continent's contentions.

The court first addressed the "defective work" exclusion that purportedly bars coverage for "any and all costs associated with the removal or replacement of the defective, deficient or faulty work."[167] Relying on *Mid-Continent Casualty Co. v. McCollum Custom Homes, Inc.*, the insurer claimed the exclusion barred all coverage for the underlying lawsuit even though the decision in *McCollum Custom Homes* was that the identical exclusion only barred coverage for some of the damage alleged in the underlying lawsuit made the subject of that coverage dispute.[168] In that case, in pertinent part, the court applied to exclusion to bar coverage for "property damage" to defective work but found it inapplicable to "property damage" to other parts of the property that were not alleged to be "defective," "deficient," or "faulty."[169]

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[162] *Mid-Continent Cas. Co. v. JTH Custom Homes, Inc.*, Case No. 1:21-cv-00520-LY, 2022 WL 2441855 (W.D. Tex. July 4, 2022), *report and recommendation adopted by* 2022 WL 17732682 (W.D. Tex. Sept. 6, 2022).

[163] *JTH Custom Homes*, 2022 WL 2441855, at *2.

[164] *Id.* at *3. As a result of the ultimate determination that a duty to defend was owed, the case was stayed as to the duty to indemnify. *See* 2022 WL 17732682, at *2.

[165] *JTH Custom Homes*, 2022 WL 2441855, at *7.

[166] *Id.*

[167] *Id.* at *8.

[168] *Id.* (citing *McCollum Custom Homes*, 461 F. Supp. 3d 516 (S.D. Tex. 2020), *appeal dismissed*, No. 20-20439, 2020 WL 8569300 (5th Cir. Oct. 28, 2020)).

[169] *Id.* (citing *McCollum Custom Homes*, 461 F. Supp. 3d at 526).

Utilizing that same distinction, the court in *JTH Custom Homes* found the "defective work" exclusion did not negate the duty to defend. In particular, while the court agreed that many of the allegations in the underlying lawsuit were claims for costs to repair or replace the insureds' defective or substandard work, the underlying plaintiffs also alleged claims of door and window leaks that caused "water damage to the flooring" as opposed to defects in the flooring causing the damage.[170] "Under the reading of the exclusion and Petition most favorable to the insureds, the allegations of water damage are not excluded because the exclusion only bars coverage for the cost of repairing or replacing the defective work itself, not the cost of resolving additional damage."[171]

The court then turned to the "damage to property" exclusions (or the "your work" exclusions) cited by Mid-Continent.[172] As with the "defective work" exclusion, Mid-Continent argued that the "damage to property" exclusions operated as a complete bar to coverage for the underlying lawsuit. Relying on the Fifth Circuit's decision in *Mid-Continent Casualty Co. v. JHP Development, Inc.*, however, the Western District disagreed.[173] In *JHP*, the insured argued that exclusion j.(6) applied only to damage to property that was the subject of defective work but did not apply to damage to parts of the project that were the subject of nondefective work, and the Fifth Circuit agreed.[174] Similarly, in the facts before the court, the underlying plaintiffs alleged "that defective work caused damage to parts of the Property with nondefective work, such as damage to interior finishes, walls, and flooring due to leaking windows and doors."[175] Thus, as in *JHP*, exclusion j.(6) did not apply to negate Mid-Continent's duty to defend.

Turning to exclusion j.(5), the court noted that, in *JHP*, the Fifth Circuit emphasized the phrase "are performing operations" as being a further limitation on the scope of the exclusion, making clear that it applies only when property damage occurs during the course of construction.[176] Because the underlying plaintiffs in this case did not state when the damage at issue occurred, at a minimum, a fact issue existed as to whether damage occurred only during construction.[177]

In sum, "[a]pplying the 'eight corners' rule and construing the Petition liberally, at least one claim falls within the scope of the Policies." As such, the magistrate judge recommended that

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[170] *Id.*

[171] *Id.*

[172] *Id.* The court's reference to exclusions j.(5) and j.(6) exclusions as "your work" exclusions may result in confusion because the "Damage to Your Work" exclusion (which is exclusion l. in a standard CGL form) is more commonly referred to as the "your work" exclusion. Because exclusion l. was replaced by the "defective work" exclusion, however, that confusion did not exist in this case.

[173] *Id.* (citing *JHP Dev., Inc.*, 557 F.3d 207 (5th Cir. 2009)).

[174] *Id.* (discussing *JHP Dev., Inc.*, 557 F.3d at 214).

[175] *Id.*

[176] *Id.* at *9.

[177] *Id.*

Mid-Continent's motion for summary judgment on the duty to defend be denied.[178] And the district court agreed.[179]

D. Commentary

Like in *McMillin Texas Homes*, the court in *JTH Custom Homes* applied well-established rules of insurance contract interpretation that operate in favor of the insured. In doing so, the court construed the allegations liberally and narrowly construed the scope of the exclusions at issue. Importantly for smaller contractors and subcontractors with policies issued by Mid-Continent and other similar insurers, the court made clear that the "defective work" exclusion (and, arguably, other "faulty work" exclusions like it) simply are not construed as broadly in their application as insurers would like them to be interpreted. Certainly, insurers know how to exclude coverage for damage to the insured's work—Form CG 22 94, which eliminates the subcontractor exception to exclusion l., is the prime example; however, insurers seem to be attempting to be less obvious about what they are excluding. As a result, creative exclusions like the "defective work" exclusion used by Mid-Continent simply are being construed as written, with courts applying them narrowly.

V. Honorable Mention

A few more cases from the last year in the world of construction-related insurance deserve some recognition:

A. *DD&B Construction, Inc. v. The Hanover Insurance Co.*, No. 5-20-CV-00182-FB-RBF, 2022 WL 329339 (W.D. Tex. Feb. 2, 2022), *report and recommendation adopted,* 2022 WL 1518941 (W.D. Tex. Sept. 6, 2022)

On February 2, 2022, a magistrate judge of the Western District of Texas addressed a summary judgment involving a builder's risk policy. In that case, a contractor (DD&B) sought payment from an insurer (Hanover) for remediation work it performed on a project owned by PHG Stone Oak. DD&B and Hanover entered into a settlement agreement by which Hanover was to pay $195,000 to DD&B for the remediation, but Hanover did not remit payment to DD&B; rather, it sent the payment to PHG Stone Oak in reliance on the owner's representation that it would, in turn, tender the funds to DD&B. The owner, however, refused to tender the funds, claiming that they were incorporated into a settlement of a state court lawsuit between PHG Stone Oak and DD&B. Hanover argued that a collateral agreement existed for providing the funds to PHG Stone Oak on DD&B's behalf. The magistrate judge found that Hanover had acted consistently with that collateral agreement and, therefore, recommended that Hanover prevail on its motion for summary judgment with respect to plaintiff's breach of contract and quantum meruit claims. On March 9, 2022, the district court judge adopted the report and recommendation in full.

[178] *Id.*

[179] *JTH Custom Homes*, 2022 WL 17732682, at *2.

B. *Arch Insurance Co. v. Soprema, Inc.*, No. 05-20-00586-CV, 2022 WL 557473 (Tex. App.—Dallas Feb. 24, 2022, no pet.)

On February 24, 2022, the Dallas Court of Appeals reviewed a contractual waiver of subrogation provision and broadly interpreted the language contained therein. The case involved a "property damage" claim on a project that was paid by the general contractor's commercial general liability ("CGL") insurer. The CGL insurer then sought to recover its payment from its insured's subcontractor, who refused the claim based on the waiver language that provided the waiver applied to a claim covered by "property insurance applicable to the work." The court rejected the insurer's argument that the provision did not apply because the "property insurance" was meant to reference a separate builder's risk policy instead of the CGL insurance policy, finding that the term was undefined, was not used in a technical manner, and, when considering the ordinary meaning of the phrase, was broad enough to include both the builder's risk policy and the CGL policy.

C. *Maxim Crane Works, L.P. v. Zurich American Insurance Co.*, 642 S.W.3d 551 (Tex. 2022)

On March 4, 2022, the Supreme Court of Texas weighed in on a dispute over the term "employee" in the Texas Anti-Indemnity Act, which is codified at Chapter 151 of the Texas Insurance Code. In particular, a lessor of a crane sought additional insured coverage from a subcontractor's insurance policy following an injury to the general contractor's employee as a result of the subcontractor's employee's conduct. In an effort to trigger the "employee" exception to the Act's prohibition on certain indemnity agreements and additional insured requirements, the lessor argued that the term "employee" should be interpreted as it is under the Texas Workers' Compensation Act ("TWCA"). The Court, however, refused to do so, finding that "the TWCA does not affect the enforceability of an additional-insured provision under the TAIA" and holding that the Act barred the lessor's additional insured claim.

D. *Mt. Hawley Insurance Co. v. J2 Resources, LLC*, Civ. A. No. 4:20-CV-2540, 2022 WL 1785483 (S.D. Tex. June 1, 2022)

On June 1, 2022, the Southern District of Texas granted summary judgment to an insurer on the duty to defend in connection with an underlying dispute pertaining to the purchase, delivery, and installation of defective pipe. While the owner of the project at issue alleged that the pipe "exhibited excessive chipping and coating failure[,]" and "[t]he coating was not adhering to the pipe and also failing in flexibility," the court held that no "property damage" existed. The court reasoned that a manufacturing defect existed prior to delivery to the project, and no allegations existed that it was damaged after it was installed or that the defective pipe caused damage to any other property. The owner also had not sought "loss of use" damages; rather, the damages sought were for the removal and replacement of the defective pipe. In dicta, having already found that the threshold requirement of "property damage" did not exist, the court also found that the "damage to your product" and "damage to impaired property" exclusions also would apply to negate the duty to defend. Because the underlying lawsuit between the owner and the insured had settled, the court also decided the duty to indemnify, finding that the insured failed to submit any evidence to establish a genuine issue of material fact on the issue.

E. *Moreno v. Sentinel Insurance Co., Ltd.*, 35 F.4th 965 (5th Cir. 2022)

On June 2, 2022, the United States Court of Appeals for the Fifth Circuit decided a duty to defend case, holding that the insurer had no obligation to defend its insured in an underlying lawsuit for which no coverage was requested. The court found that the insurer had knowledge of the lawsuit (and defended an additional insured without reservation of rights), but the named insured had not sought coverage from its insurer on the belief that no coverage would be available for an employee injury claim. When the lawsuit subsequently was amended to assert that the injured party was actually an independent contractor, the insured did not seek coverage either. Thus, a subsequent agreed judgment in favor of the injured party was not enforceable against the insurer, who had been prejudiced by the insured's conduct, so there was no duty to indemnify either.

F. *Ohio Casualty Insurance Co. v. Patterson-UTI Energy, Inc.*, No. 14-22-00026-CV, 2022 WL 17097132 (Tex. App.—Houston [14th Dist.] Nov. 22, 2022, rule 53.7(f) granted)

On November 22, 2022, the Fourteenth District Court of Appeals in Houston addressed an excess insurer's obligation to reimburse its insured's defense costs. The insurer contended that no such obligation existed because the excess policy did not provide for a duty to defend. The court, however, held that the primary liability policy over which the excess policy sat did cover defense costs and the excess policy purported to "follow form." Thus, the court found that reimbursement was required even though the excess policy did not include the same "ultimate net loss" term as the primary policy and relied only on the term "loss." The court explained that, while that was true, the excess policy covered "damages," which was not independently defined in the excess policy and, therefore, relied on the definition of that term from the primary policy, which included defense expenses.