UNDERSTANDING THE RIGHTS OF INSUREDS IN INSURANCE COVERAGE DISPUTES INVOLVING BUILDERS RISK AND COMMERCIAL GENERAL LIABILITY POLICIES

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I. INTRODUCTION

Having a claim brought against your company can be a distressing event. For many companies, including construction entities, a good part of the stress involved with a claim being brought by a former client or a third party is the inevitable question: "does our insurance cover this?" Even more stressful is what happens after you have tendered the claim to your insurance carrier and have been informed that they have answered that question with a "no," or something similar.

This paper will discuss the general rights that insureds hold after a dispute has arisen over coverage of a claim with their insurance carrier.

II. ISSUES TO CONSIDER UPON PRESENTATION OF A CLAIM

What Constitutes a Claim?

Claims are filed against business entities and individuals by the thousands on a daily basis. They come in all forms. However, a claim is essentially a demand levied by one person or entity against another for compensation due to an alleged loss sustained by the claimant due to some alleged act of the claimee.

It appears that a very common form of a claim that is presented to a business entity, such as a general contractor or subcontractor, is a demand letter that has been sent to your attention by a claimant's attorney. However, frequently the first that your company may hear of a claim is when your registered agent receives service of process for a lawsuit filed against you. But a claim itself can be something as simple as a customer complaint about craftsmanship and an expectation that your company will repair some claimed defect, such as a roof leak. See *Blanton v. Vesta Lloyds Ins. Co.,* 185 S.W.3d 607 (Tex. App. – Dallas 2006, no pet).

In essence, the safe rule for protecting you coverage is to report any complaint or demand against you where the complaining person is claiming some measure of damage as a result of their allegations against you. In other words, if they expect to you reimburse or compensate them in any way in connection with their complaint – report it.

Provide Notice of Claim to Insurance Carrier Immediately:

Regardless of how the demand or claim came to your attention, it is imperative that your insurance carrier be notified by the claim immediately upon your receipt of the claim. Failure to tender the claim in a timely fashion can bring your insurance coverage into jeopardy.

In *Blanton v. Vesta Lloyds Ins. Co.,* 185 S.W.3d 607, (Tex. App. – Dallas 2006, no pet), a claimant had informed an insured entity that they had experienced roof leaks, which they alleged had caused property damages. The complaints were reported approximately two years prior to the filing of a lawsuit against the insured. Upon the filing of the lawsuit, the insured promptly tendered the plaintiff's petition to its insurance carrier. The carrier denied coverage on the basis that the insured had failed to promptly provide notice of the claim. The Dallas Court of Appeals agreed with the carrier citing that to comply with the provisions of a commercial general liability policy, notice of an occurrence or accident be given "as soon as practicable." In this case, the Court held that the delay of had hindered the insurer's ability to

adequately investigate the claims brought by the insured, which prejudiced the carrier.

Provide Your Carrier With Everything:

It has been said that the "devil is in the details," well, nothing can be further from the truth when in the instance of an insurance carrier determining whether or not a claim is covered under a policy. Insurance adjusters and the carrier's coverage attorneys compile large claim files and review the materials provided by the insured and the claimant to determine the issue of coverage.

Assemble All of Your Insurance Policies:

In the modern construction industry, frequently companies are insured under multiple policies of insurance, with different layers of coverage and obligations to indemnify and defend you against a claim or lawsuit. While you might think that you know which policy would be responsible for covering the claim, it is best to place all of your applicable carriers on notice of the claim. Moreover, your general liability carrier will also require policies of excess and umbrella coverage to assist them in their investigation of the claim.

What Type of Insurance Covers My Claim?

Typically, construction entities are covered under a commercial general liability policy (CGL). However, many in the construction industry also carry builders risk insurance. The distinction of which of these policies would provide coverage for your claim can be quite confusing, especially in coverage for property damage during "ongoing operations." Coverage under the CGL policy for ongoing operations is narrower than for "completed operations." Coverage for this type of loss may exist under a builders risk policy, but it too has its limitations.

Builders Risk Insurance:

Builders risk insurance is a type of insurance that only covers projects under construction, renovation or repair. Contractors and others who are involved in construction should rely on builders risk as their primary means of recovery from losses to the work that occur during the course of construction.

Builders risk policies are designed to cover a wide range of direct and sometimes indirect property exposures associated with construction projects. A builders risk policy usually covers the structure under construction; materials, fixtures, supplies, machinery, and equipment to be used in the construction; property of others for which an insured may be liable; and removal of debris of covered property that is damaged in a covered loss.

Commercial General Liability Insurance:

CGL policies are a principal means of insuring against personal injury and property damage which occur as a result of the contractor's activities on the job site. Property damage that occurs to a project during construction is considered to have occurred during ongoing operations. Property damage that occurs after the completion of the construction project is considered completed operations.

Excess and Umbrella Policies and Other Policies:

Excess insurance, also known as umbrella policies, provide additional coverage when the limits of insurance on an underlying policy are exceeded. There can

be multiple different excess insurers offering different layers of coverage. For instance, if you have $1,000,000 coverage under a CGL policy, you have a claim settlement for $1,500,000; the excess policy would pick up the additional amount. As such, it is important to make sure that your agent or broker has informed all of your excess or umbrella carriers of the circumstances of your claim.

In addition to the above-referenced policies, depending on your company, you may have other policies that are not as common, but may be applicable, such as Environmental Impairment Liability Insurance, Surety Bonds (for governmental projects).

Tender Your Claim to All Applicable Carriers:

As a practical matter you should tender notice of a claim under any possibly applicable policies, whenever you sustain a loss or have any reason to believe that a claim may be asserted against you. Allan Windt, INSURANCE CLAIMS AND DISPUTES: REPRESENTATION OF INSURANCE COMPANIES AND INSUREDS, Fifth Edition §1.1 (2007).

In short, you should make certain that your agent or broker has made all of the applicable insurers aware of the claim(s) asserted against you. By covering these bases you might prevent a coverage dispute at a later date.

III. VARIOUS POLICY EXCLUSIONS COMMONLY RELIED UPON BY INSURERS IN COVERAGE DISPUTES WITH INSUREDS IN THE CONSTRUCTION INDUSTRY

All insurance coverage disputes involve the interpretation of the policy language in question. As such, it is important to understand the exclusionary language that is included in the most common types of policies relied upon by the construction industry to understand the nature of the position brought forth by the carrier when coverage is denied.

Common Policy Exclusions in Builders Risk Policies:

The Builders Risk forms contain numerous exclusions. Common builder’s risk peril exclusions include: There are many variations in these exclusions, and modifications to them can often be negotiated. An exclusion of particular importance is the workmanship exclusion. In addition, insurers often cite the latent defect exclusion as a basis to deny coverage for losses involving defective construction. The inherent vice exclusion is a sister exclusion to the latent defect exclusion. Although there are numerous exclusions in the builders risk form, only these three exclusions will be discussed below.

A. Workmanship Exclusion

All builders risk policies contain exclusions applicable to losses caused by faulty workmanship or materials. The purpose of the exclusion is the same as for the CGL faulty workmanship exclusion-to avoid insuring part of the contractor's "business risk." However there are two different approaches to the exclusion, and one limits coverage to a much greater extent than does the other.

The most restrictive workmanship exclusions preclude coverage for all loss resulting from faulty workmanship or materials. While these exclusions vary, some examples are as follows:

- The cost of making good;
  - Defective design
  - Defective specifications
  - Faulty materials
  - Faulty workmanship
  - Except resulting
- Wear, tear, corrosion, erosion, inherent vice, latent defect (except resulting)
- Settling, shrinkage or expansion of foundations, walls, floors, ceilings (except resulting)
- Equipment Warranty Claims

Restrictive Builders Risk Workmanship Exclusions

1. Loss, damage, or expense caused by or resulting from error, deficiency in design, specifications, workmanship, or materials.
2. Loss or damage caused by faulty materials, improper workmanship or installation, errors in design or specifications.
3. Loss caused directly or indirectly by inherent vice, latent defect, faulty materials or workmanship, or error in design, unless fire or explosion ensues, and then only for loss or damage caused by the ensuing fire or accident.

Under the less restrictive approach to the workmanship exclusion, only damage to the faulty work or materials themselves is excluded. Some examples of exclusions that take this approach are as follows:

Less Restrictive Builders Risk Workmanship Exclusions

1. Cost of making good faulty workmanship, construction, or design, but this exclusion shall not apply to damage resulting from such faulty workmanship, construction, or design, unless specifically excluded elsewhere herein.
2. Cost of making good faulty or defective workmanship, material, construction, or design, but this exclusion shall not apply to damage resulting from such faulty or defective workmanship, material, construction, or design.
3. To buildings or structures under construction resulting from the cost of making good faulty workmanship, material construction, or design, but this exclusion shall not apply to loss arising as a consequence of faulty workman-ship, material, construction, or design.
4. Cost of making good faulty or defective workmanship or material, but this exclusion shall not apply to physical damage resulting from such faulty or defective workmanship or material.

This type of exclusion is preferable because it causes the policy to cover resulting damage to good work.

When faced with workmanship exclusions, courts often distinguish between a faulty process and a faulty product, upholding coverage for loss arising out of a faulty process, as opposed to a faulty product. In *Allstate Ins. Co. v. Smith*, 929

F.2d 447 (9th Cir. 1991), the insured under an all risk insurance policy sought coverage for damage caused by a rainstorm when a roofer failed to put a temporary cover over the exposed premises at night.

The court declined to apply a faulty workmanship exclusion. Since failing to put a temporary cover on the roof during construction constituted a faulty process, the court held that it was not within the scope of the faulty workmanship exclusion, which applies only to a faulty product, which is the existence of an object to evaluate. Since the roofer had not completed any portion of the new roof when the damage occurred, there was no object to evaluate to determine whether the workmanship was faulty. In addition, the court stated: The flawed product interpretation is also bolstered by the provision in the "faulty workmanship" exclusion that "any ensuing loss not excluded or excepted in this policy is covered." *Id.* at 450.

Even though many of the damages arising out of defective construction constitute the cost of making good design error or faulty workmanship, the ensuing loss clause may nevertheless apply to except many of those damages from the exclusion. Courts that have applied this type of ensuing loss clause have held that there is coverage for the damage to other work caused by the defective item of work. For example, in *National Fire Ins. Co. of Pittsburgh v. Valero Energy Corp*., 777 S.W.2d 501 (Tex. App.-Corpus Christi 1989, writ denied), Valero, the insured, brought suit on a builders risk policy for the costs associated with repair and replacement of defective and damaged components of a citrate scrubber installed during a refinery expansion project. The policy was written on an all risk form insuring against all occurrences causing physical loss or damage to the property used in the expansion project. When the citrate scrubber was tested, it sustained substantial damage as a result of faulty design, since the engineers had failed to anticipate the environment and forces to which the components of the scrubber would be exposed, resulting in corrosion. The corrosion left holes in the transition piece of the scrubber that allowed flue gas and acid to escape. The faulty design also caused corrosion and physical damage to the demisters which could not stand the force of the flow because they were made of inadequate plastic material. As a result of the defects and resulting damage, Valero had to shut down the refinery several times to make repairs and alterations, and to replace portions of the equipment. *Valero* at 505. In response to the claim, the insurer denied coverage based on the faulty workmanship and design exclusion. However, the exclusion was subject to an exception for "physical loss or damage arising as a consequence of faulty workmanship, material, construction, or design." In refusing to apply the exclusion, the court illustrated how broadly the ensuing loss clause is applied as follows:

> The loss in the present case can be characterized in either or both ways: the use of an inadequate transition piece and demisters required Valero to replace them in order to "make good" the faulty design; however, as a consequence of the faulty design and the inadequacy of the components, there was also physical damage to the transition piece and demisters which necessitated their replacement. The court must adopt the construction of an exclusionary clause which favors the insured as

> long as that construction is not unreasonable. *Blaylock v. American Guarantee Bank Liab. Ins*. Co., 632 S.W.2d 719, 721 (Tex. 1982); *Glover v. National Ins. Underwriters,* 545 S.W.2d 755, 761 (Tex. 1977). In the present case then, characterizing the loss sustained as a consequence of the faulty design brings it within the exception to the exclusion and thus within the coverage of the policy. *Valero* at 506.

Another case applying an ensuing loss clause is *Adrian Assoc., Gen. Contractors v. National Sur. Corp.*, 638 S.W.2d 138 (Tex. App.-Dallas 1982, writ refd n.r.e.). In that case, the contractor, due to the rupture of an underground water main, was required to tear out and reconstruct portions of a concrete slab that subsided or settled. The contractor sought coverage under the all risk builders risk policy, and one of the exclusions relied on by the insurer was the settlement of foundation exclusion. *Adrian Assoc*. at 139. The court held that the exclusion did not apply due to an ensuing loss clause which stated that it did not apply to losses resulting from a peril not excluded under the policy. Since the loss did not result from a peril not excluded due to underground water, the settlement to the foundation exclusion did not apply. *Id.* at 141.

As is the case with many complex construction losses, the applicability and scope of a faulty workmanship exclusion in an all risk or builders risk policy often requires a complex factual determination, usually with the aid of expert testimony.

B. Latent Defect Exclusion

The latent defect exclusion is often cited by insurers as a basis to deny coverage for losses involving defective construction. Various cases have refused to apply the latent defect exclusion. *Essex House v. St. Paul Fire & Marine Ins. Co.*, 404 F.Supp. 978 (S.D. Ohio 1975) involved a suit on an all risk policy to recover damages sustained when a large portion of the face brick detached from the insured building. The court found that the building suffered from numerous construction defects, including lack of control joists in the masonry walls, improper location of window openings resulting in overstress to the concrete block back-up walls, unauthorized deviation from the bonding patterns called for in the plans resulting in the brick facing wall having only 30 percent of the headers called for, and other construction deficiencies which generally overstressed and weakened the structure. *Essex House* at 983.

Based upon these facts and its determination that the loss resulted from temperature differentials coupled with the negligent construction, the court concluded that the latent defect exclusion in the policy did not apply, rejecting the insurer's contention that the deficiencies were incorporated into and began to work upon the structure from its inception. The court noted that a visual inspection of the insured building and the construction plans would have been sufficient to detect the construction deficiencies, and it also held that negligent design and workmanship do not constitute an inherent vice or latent defect. Essex House at 993.

Another case refusing to apply the latent defect exclusion is *Fidelity & Guaranty Ins. Underwriters, Inc. v. Allied Realty Co., Ltd.,* 384 S.E.2d 613 (Va. 1989). In that case, the insured sought coverage for

damage due to the rotation of cinder block warehouse walls. One of the exclusions relied upon by the insurer was the latent defect exclusion. The court held that based upon the jury's finding that the cracking and bulging to the walls was due to fill pressure, and not the wall itself, the inherent or latent defect exclusion did not apply.

In *Stoneman-Schopf Agency, Inc. v. Green Briar Homes, Inc*., 326 N.W.2d 781, 1982 WL, 171754 (Wis. App. 1982), a house settled as a result of groundwater flowing between large stones placed in the excavation site. The builder knew about the water and used the stones to provide a more solid base for the house. The damage could have been prevented if the builder had filled the spaces between the stones with concrete. On these facts, the court held that the insurer owed coverage under the property policy before it. The flowing groundwater was an external force relative to the construction of the home and its presence on the land did not make it an inherent or latent defect of the house.

Commentators have observed that the latent defect exclusion, standing alone, is of little utility. If the insurer intends to exclude from coverage what was formerly considered a latent defect, it must do so "through an augmented exclusion including negligence or defects in workmanship, design or construction." Andrew C. Hecker, Jr. and M. Jane Goode, *Wear and Tear, Inherent Vice, Deterioration, Etc.: The Multi-Faceted-Risk Exclusions,* 21 TORT & INS. L. J. 634 (Summer 1986).

C. Inherent Vice Exclusion

The inherent vice exclusion relates to a loss resulting entirely from internal decomposition or some quality which brings about the property's own injury or destruction. The vice must be inherent in the property for which recovery is sought. *Employers Casualty Co. v. Holm,* 393 S.W.2d 363, 367 (Tex. Civ. App.-Houston 1965, no writ).

In *M. A. Mortensen Co. v. Indemnity Ins. Co. of North America*, 1999 U.S. Dist. LEXIS 22641 (D. Minn. December 23, 1999), the contractor constructed a subgrade for a high school building project, but the site work was destroyed by an unusually heavy rainstorm. The builders risk insurer denied coverage based, in part, on the inherent vice exclusion, contending that the soil used by the contractor, which had high silt content, was unsuitable for compaction and for use in the subgrade because of its high moisture sensitivity. According to the insurer, the damage resulted from an "inherent vice" because the subgrade was ruined when rain fell on the highly moisture-sensitive soil. In response, the contractor argued that "inherent vice" refers to damage caused entirely by an intrinsic quality and thus could not include damage that requires an external force such as rain to cause it. The court agreed with the insured contractor and held that an inherent vice relates only to damage caused solely by internal decomposition.

Common Exclusions in Commercial General Liability Policies:

a. Business Risk Exclusions: j (5) and (6)

Both exclusion j(5) and j(6) have the common goal of seeking to bar coverage for losses arising out of the insured’s work. These exclusions bar coverage during a period of time in which the insured should be able to notice any problems of faulty workmanship that manifests. The insured presumably does not have the same opportunity to notice its faulty workmanship when the damage is caused by hidden

defects and this situation will usually find coverage, despite the business risk exclusions.

The CGL policy contains the following property damage exclusions that apply to property damage that occurs prior to completed operations:

> j. Damage to Property
> "Property damage" to:
>
> * * *
>
> (5) That particular part of real property on which you or any contractors or subcontractors working directly or indirectly on your behalf are performing operations, if the "property damage" arises out of those operations; or
> (6) That particular part of any property that must be restored, repaired or replaced because "your work" was incorrectly performed on it.
>
> * * *
>
> Paragraph (6) of this exclusion does not apply to "property damage" included in the "products-completed operations hazard."

The commercial general liability policy also contains the following definition:

> 22. "Your work"
> a. Means:
> (1) Work or operations performed by you or on your behalf; and
> (2) Materials, parts or equipment furnished in connection with such work or operations.
> b. Includes:
> (1) Warranties or representations made at any time with respect to the fitness, quality, durability, performance or use of "your work"; and
> (2) The providing of or failure to provide warnings or instructions.

Exclusions j(5) and j(6) apply to ongoing operations or operations that are not yet completed. *See CU Lloyd's of Texas v. Main Street Homes, Inc.*, 79 S.W.3d 687 (Tex. App.—Austin 2002, no pet.). Whether j(5) and j(6) apply depends on whether the work performed by the insured was completed prior to the manifestation of damages. If the construction project was completed prior to the manifestation of the damages, exclusions j(5) and j(6) do not apply. However, if the operations were still ongoing, then exclusions j(5) and j(6) may apply, but only to the particular part of property upon which the insured was working, discussed in detail in subsequent sections.

<u>Exclusion j(5)</u>

Exclusion j(5) bars coverage for property damage that is caused at the time the insured is still actually performing work. This exclusion applies equally to contractors and subcontractors who are performing work on behalf of the policyholder. If the policyholder is the general contractor, exclusion j(5) bars coverage for "property damage" to real property that arises out of operations performed by or on behalf of the policyholder.

In addition, the exclusion, by its terms, only relates to "that particular part" of the property on which the work is being performed. When damage caused by the insured while operations are still ongoing goes beyond damage to the property on which the insured is working, the exclusion is limited to "that particular part" on which

the insured was working at the time. Thus, for example, if an insured is working on the windows of a condominium complex and causes damage to the windows, the property damage to the windows will be excluded under j(5). However, if the insured was not working on the windows at the time of the damage, or if the damage occurs to a different part of the property, such as the walls, exclusion j(5) will not bar coverage for the property damage to the walls.

Exclusion j(6)

Exclusion j(6) is very much like j(5) because it also bars coverage for "that particular part" of property damage that is caused by faulty workmanship. However, j(5) and j(6) differ in several important respects. Most significantly, exclusion j(6) contains a specific exemption for property damage that occurs within the completed operations hazard. Exclusion j(5) and j(6) apply to property damage that occurs during the period work is being performed. *See Jim Johnson Homes, Inc. v. Mid-Continent Casualty, Co.*, 244 F. Supp.2d 706, 717-19 (N.D. Tex. 2003). Additionally, exclusion j(6) applies to work being performed either on or off the insured's premises. Exclusion j(6) applies to "your work," a term defined in the policy to include work or operations performed by the insured or subcontractors on its behalf.

In *Dorchester Dev. Corp. v. Safeco Ins. Co.*, 737 S.W.2d 380 (Tex. App.—Dallas 1987, no writ) Safeco relied upon exclusion j(6) to deny defense to Dorchester against claims of damages resulting from construction by Dorchester of an apartment complex in Dallas. The exclusion applied to "the restoration, repair or replacement of which has been made or is necessary by reason of faulty workmanship thereon by or on behalf of the insured." *Id*. at 382. The Dallas Court of Appeals held that the exclusion was applicable because the only claim against Dorchester was for the failure of Dorchester to repair or remedy the defective concrete flooring on the third floor and other defects in the apartment complex. While the court recognized that the exclusion applied to faulty workmanship, the court qualified its ruling so that the exclusion did not apply to damage to property other than the insured's defective work, including other work of the insured that was not defective.[1]

However, the exclusion does not eliminate coverage for damage to other property caused by the defective work. Additionally, exclusion j(6) applies only to "that particular part of any property that must be restored, repaired or replaced [by reason of faulty workmanship] performed on it." Thus, to be excluded from coverage, the particular part of the property which sustained damage must either be (1) the faulty portion of the insured's itself, or (2) the particular part of the property which is not the insured's work, but which is being worked on by the insured in a faulty manner. This exclusion is not limited to the work of the insured. It can include damages caused

[1] It has been questioned as to what effect the Lamar Homes decision has on exclusion j(6). Please note that in *Lamar Homes*, the carrier was not relying upon the language of exclusion of j(6), rather the carrier was arguing that the "economic-loss" rule precluded coverage, urging that damage to the insured's own work is not "property damage" but rather a contractual, economic loss. In this regard, the carrier argued that "property damage" meant liability at tort, rather than liability for a contractual breach of workmanship. The Texas Supreme Court disagreed with the carrier's assertions and reviewed a subcontractor exception to the "your work" exclusion that was applicable in the case and held that the claim for construction defect was covered. *Lamar Homes, Inc. v. Mid-Continent Cas.* Co., 2007 Tex. LEXIS 797. (Tex. 2007).

by subcontractors based on the definition of "your work" in the policy.

b. Impaired Property Exclusion

The "impaired property" exclusion also operates in concert with the faulty workmanship and "your work" exclusions to bar business risks of the insured. The impaired property exclusion reads as follows:

> **m. Damage to Impaired Property or Property Not Physically Injured**
> "Property damage" to "impaired property" or property that has not been physically injured, arising out of:
> (1) A defect, deficiency, inadequacy or dangerous condition in "your product" or "your work"; or
> (2) A delay or failure by you or anyone acting on your behalf to perform a contract or agreement in accordance with its terms.
> This exclusion does not apply to the loss of use of other property arising out of sudden and accidental physical injury to "your product" or "your work" after it has been put to its intended use.

The policy defines "impaired property" as:

> 7. "Impaired property" means tangible property, other than "your product" or "your work", that cannot be used or is less useful because:
> a. It incorporates "your product" or "your work" that is known or thought to be defective, deficient, inadequate or dangerous; or
> b. You have failed to fulfill the terms of a contract or agreement;
>
> if such property can be restored to use by:
> a. The repair, replacement, adjustment or removal of "your product" or "your work"; or
> b. Your fulfilling the terms of the contract or agreement.

This exclusion is intended to apply where there is no actual physical injury to property, but where property is impaired because of a defect, deficiency, inadequacy or dangerous condition in "your product" or "your work." *See Mt. Hawley Ins. Co. v. Steve Roberts Custom Builders, Inc.*, 215 F.Supp.2d 783, 792 (E.D. Tex. 2002) (noting "[e]xclusion (m) applies to "impaired property" and not to property that has been physically injured"); *McKinney Builders II, Ltd. v. Nationwide Mut. Ins. Co.*, No. CIV. A. 3:97-CV-3053, 1999 WL 608851, *9 (N.D. Tex. 1999) ("First, exclusion (m) is inapplicable because, as noted above, the Underlying Petition alleges property damage based on physically injured property. Thus, exclusion (m), which applies only to "impaired property" or "property that has not been physically injured" is inapplicable. Second, construing the Underlying Petition's allegations as property damage to "impaired property" creates an ambiguity that requires a strict construction of this exclusion against Defendants."). Note that the insured's work and the insured's product cannot be "impaired property." The policy definition states that "impaired property" is tangible property other than "your work" or "your product."

In other words, the "impaired property" exclusion bars coverage for

economic losses arising from damage to another's property caused by the incorporation of an insured's faulty workmanship or materials into a larger product. *See* Joseph G. Blute, ANALYZING LIABILITY INSURANCE COVERAGE FOR CONSTRUCTION INDUSTRY PROPERTY DAMAGE CLAIMS, COVERAGE (Committee on Insurance Coverage Litigation Report), May/June 1997, at 31; *see also Lennar Corp. v. Great American Ins. Co.*, 2005 WL 1324833 (Tex. App.—Houston [14th Dist.] 2005) (unpublished opinion) (holding that exclusion m. might arguably apply to the replacement of EIFS on homes, but does not apply to the costs incurred by the insured to repair physical injury caused by water damage to the homes); *T. C. Bateson Constr. Co. v. Lumbermen's Mut. Casualty Co.*, 784 S.W.2d 692 (Tex. App.–Houston [14th Dist.] 1989, writ denied) (holding "impaired property" exclusion was unambiguous and applied to exclude the cost of repair and replacement of marble slabs that were attached to a building in a defective manner); *Federated Mut. Ins. Co. v. Grapevine Excavation, Inc.*, 197 F.3d 720 (5th Cir. 1999) (refusing to apply the impaired property exclusion because the defect could not be cured without removing or destroying the other work that was alleged to be the "impaired property"; the top layer of the asphalt parking lot, which was alleged to be the "impaired property," could not be restored to use by the repair, replacement, adjustment or removal of the insured's work, which constituted the select fill material underlying the asphalt, without tearing up the parking lot).

In addition, the exclusion specifically provides that the impaired property must be capable of being restored by the repair or replacement of the insured's work or product before it will operate to bar coverage. The exclusion will not apply, however, to any loss arising out of a "sudden and accidental" injury to "your work" or "your product" after it has been put to its intended use. Coverage is not barred where the claim arises out of the "loss of use of other property arising out of sudden and accidental physical injury to the insured's product or work after it has been put to its intended use." For example, if a crane suddenly and accidentally collapses at a job site. If the collapsed crane blocks access to businesses caused loss, coverage for loss of use of claims brought against the insured contractor should fall within the exception to the exclusion.

The "impaired property" exclusion, therefore, is narrowly limited to economic losses caused by the insured's failure to comply with its workmanship obligations, so long as the damaged property can be repaired.

IV. REJECTION OF CLAIMS VERSUS RESERVATION OF RIGHTS

When a claim is made under a policy by the insured, the carrier must determine whether the complaint against the insured gives rise to the duty to defend the insured against the complaint. In the event the insured concludes that it has such a duty, but still has reservations about whether the claim is covered by the policy, the carrier will tender a "reservation of rights" letter to the insured explaining that a defense against the claims is being offered under the policy, but that the carrier reserves the right to challenge coverage at a later date. See Windt § 2:7.

If the carrier fails to tender a timely written notice of a reservation of rights, then the carrier is precluded from later denying coverage under the policy. *Id*. The

reservation must be made in a timely manner after the insurer has reason to believe that one or more claims against its policyholder are not covered. TEX. INS. CODE ANN. § 541.060(a)(4)(B).

However, a reservation of rights is not tantamount to a prospective rejection of coverage. Carriers frequently reserve rights and never challenge coverage. However, it is a necessary step for insurers to take if they want to preserve this challenge.

Moreover, it should be noted that absent a timely receipt of a reservation of rights, a carrier cannot later claim reimbursement from its insured for expenses and settlement proceeds if the carrier later determines that coverage for the claim never existed. *Excess Underwriters at Lloyds v. Frank's Casing Crew & Rental Tools, Inc.*, 48 Tex. Sup. Ct. J. 735, 2005 Tex. LEXIS 418 (Tex. 2005)

As such, it is always important to pay attention to whether or not the carrier has reserved rights, and also when the carrier provided the reservation in writing.

V. TAKING ACTION: CAUSES OF ACTION THAT AN INSURED CAN RAISE AGAINST ITS CARRIER REGARDING COVERAGE ISSUES:

After insurance carrier has rendered a negative coverage opinion, either through a rejection of coverage or through the issuance of a reservation of rights, then a policyholder should consult with counsel regarding the possibility of bringing litigation against the carrier for insurer bad faith. This is a decision that should not be taken lightly. Insurance carriers rarely make coverage decisions in a cavalier manner. Generally speaking, carriers usually have some basis to support a rejection of a claim.

However, considering the cost of litigating a construction defect claim, it is certainly worth retaining coverage counsel to review the propriety of the carrier's actions and attempt to get the carrier to provide a defense.

After your counsel has reviewed the carrier's decision, if it is determined that the carrier has wrongly declined coverage, then there are several avenues to proceed against the insurance carrier in a civil action for insurer bad faith.

1. What is Actionable under the Texas Insurance Code?

Chapter 541 and 542 of the Texas Insurance Code prohibit unfair and deceptive insurance practices. This statute allows a private cause of action by insureds who have sustained damages caused by another's engaging in any act or practice in the business of insurance that constitute a violation of the Insurance Code. TEX. INS. CODE ANN. § 541.151. While this section includes a lengthy laundry list of unfair insurance practices, the vast majority of litigation centers around one of the enumerated items: unfair settlement practices.

2. Bad Faith Litigation for Unfair Settlement Practices:

Section 541.060 of the Insurance Code provides that the following conduct by insurance carriers can be the basis behind a private cause of action by the policyholder against the insurer. Specifically, Section 541.060 states:

(a) It is an unfair method of competition or an unfair or deceptive act or practice in the business of insurance to engage in the following unfair settlement

practices with respect to a claim by an insured or beneficiary:

> (1) misrepresenting to a claimant a material fact or policy provision relating to coverage at issue;
>
> (2) failing to attempt in good faith to effectuate a prompt, fair, and equitable settlement of:
>
> (A) a claim with respect to which the insurer's liability has become reasonably clear; or
>
> (B) a claim under one portion of a policy with respect to which the insurer's liability has become reasonably clear to influence the claimant to settle another claim under another portion of the coverage unless payment under one portion of the coverage constitutes evidence of liability under another portion;
>
> (3) failing to promptly provide to a policyholder a reasonable explanation of the basis in the policy, in relation to the facts or applicable law, for the insurer's denial of a claim or offer of a compromise settlement of a claim;
>
> (4) failing within a reasonable time to:
>
> (A) affirm or deny coverage of a claim to a policyholder; or
>
> (B) submit a reservation of rights to a policyholder;
>
> (5) refusing, failing, or unreasonably delaying a settlement offer under applicable first-party coverage on the basis that other coverage may be available or that third parties are responsible for the damages suffered, except as may be specifically provided in the policy;
>
> (6) undertaking to enforce a full and final release of a claim from a policyholder when only a partial payment has been made, unless the payment is a compromise settlement of a doubtful or disputed claim;
>
> (7) refusing to pay a claim without conducting a reasonable investigation with respect to the claim
>
> TEX. INS. CODE ANN. § 541.060.

Texas courts recognize that insurers owe their insured a duty to deal in good faith with respect to the handling of claims

3. Potential Recovery for Bad Faith Litigation under Section 541:

Whenever a carrier rejects a claim, it is in violation of Section 541 if it cannot establish that coverage did not exist under the policy. Frequently, carriers seek a declaratory judgment from a court regarding the issue of coverage prior to subjecting themselves to the potential recovery that an insured can take in "bad faith" litigation against them.

The recovery allowed for violations of Section 541 are significant. Any policyholder who prevails against the insurance carrier may obtain:

- Actual damages

- Additional damages, if the carrier acted knowingly
- Costs of court
- Attorney's fees

TEX. INS. CODE ANN. § 541.152.

4. Common Law Actions for Breach of the Duty of Good Faith and Fair Dealing:

In addition to the statutory cause of action provided by Section 541, the Texas courts have acknowledged a cause of action under the common law against insurers for breaching the duty of good faith and fair dealing,

The duty of "good faith and fair dealing" was first announced by the Texas Supreme Court in *Arnold v. Nat'l. County Mut. Fire Ins. Co.*, 725 S.W.2d 165 (Tex. 1987). The Texas Supreme Court readdressed the issue in *Aranda v. Ins. Co. of North America*, 748 S.W.2d 210 (Tex. 1988) and further defined the cause of action in the early 1990's in *Lyons v. Millers Cas. Ins. Co. of Texas*, 866 S.W.2d 597 (Tex. 1993) and *Nat'l. Union Fire Ins. Co. of Pittsburgh, PA. v. Dominguez,* 873 S.W.2d 373 (Tex. 1994).

The duty of "good faith and fair dealing" doctrine stayed relatively constant until readdressed by the Texas Supreme Court in July of 1997 when it issued decisions in *The Universe Life Ins. Co. v. Giles*, 950 S.W.2d 48 (Tex. 1997), *State Farm Lloyds v. Nicolau*, 951 S.W.2d 444 (Tex. 1997), and *United States Fire Ins. Co. v. Williams,* 955 S.W.2d 267 (Tex. 1997). Under those decisions, to establish a breach of the duty of good faith and fair dealing, the insured must prove:

1) Liability was reasonably clear under the policy; and

2) The carrier delayed payment or denied the claim when it knew or should have known that liability was reasonably clear.

5. Prompt Payment of Claims:

Now that we have discussed why a carrier might reject your claim, we need to analyze your rights leading up to and following the denial.

Section 542 of the Texas Insurance Code sets forth deadlines for insurers to (a) inform insureds regarding the acceptance or rejection of the claim tendered; and (b) make payment on valid claims. Moreover, Section 542.060 imposes penalties for insurers that fail to meet the statutory deadlines.

Insurer's Acknowledgement of Receipt of Claim:

Under Texas law, an insurer has 15 days from its receipt of notice of a claim to: (a) acknowledge receipt of the claim in writing; (b) begin to investigate the claim; and (c) request all necessary documents from the policyholder. TEX. INS. CODE ANN. Section 542.055. The acknowledgement of the claim must be in writing to satisfy Section 542.055 of the Texas Insurance Code. *Daugherty v. American Motorists Ins. Co.,* 974 S.W.2d 796, 799 (Tex.App.—Houston [1st Dist.] 1998, no writ).

Insurer's Deadline to Accept or Reject Claim:

Under Section 542.056 of the Texas Insurance Code, the carrier must notify the insured in writing of its acceptance or rejection of the claim tendered before the expiration of 15 days from its receipt of all necessary documents requested from the insured. Any rejection of the claim must be in writing and must state the reason the claim was rejected. *See* TEX. INS. CODE ANN. Section 542.056.

Section 542.056 does provide an additional extension of forty-five days to the fifteen day deadline in the event that the carrier requires additional time to render a decision regarding the acceptance of the claim. *See* TEX. INS. CODE ANN. SECTION 542.056 (d). To take advantage of this extension, the insurer must notify the insured in writing prior to the expiration of the fifteen day deadline and such notice must specify the reasons the insurer requires additional time. *Id.*

Statutory Deadline to Promptly Pay Accepted Claim:

After the insurer notifies an insured that it will pay a claim (in whole or in part), it must pay the claim within five days after such notice is given. TEX. INS. CODE ANN. SECTION 542.057. If the insurer conditions payment upon some action by the insured, the insurer must pay within 5 days of the insured's performance of the required action. *Id.*

However, the carrier can withdraw the notice if it receives new information upon which it can validly deny the claim. *Daugherty,* 974 S.W.2d at 799.

The deadline in Section 542.057 is overlaid by another deadline imposed by Section 542.058, which states that an insurer must pay a valid claim within sixty days upon receiving all requested documentation from the insured or face the statutory penalties. TEX. INS. CODE ANN. SECTION 542.058.

Statutory Penalties for Violations of Section 542:

Section 542.060 provides that if the insurer is not in compliance with the deadlines imposed by Section 542, then the insurer is liable to pay the holder of the policy, in addition to the amount of the claim, a penalty of 18% per annum in damages and the insured's attorney's fees. TEX. INS. CODE ANN. SECTION 542.060.

Partial Payment of Valid Claim Does Not Protect Carrier From Statutory Penalties:

In *Republic Underwriters Ins. Co. v. Mex-Tex, Inc.*, 150 S.W.3d 423 (Tex. 2004), the insured sought payment for the destruction of its roof during a hail storm. While the insurer was investigating the matter, the insured had the roof replaced. The insurer sent a $145,460 check for the amount that it believed was the true cost of the roof work, which was less than the insured had paid. The insured refused the check, claiming that the insurer conditioned a full release in exchange for the payment. The Texas Supreme Court found that the insured failed to prove its allegation that the insurer conditioned a full release of the claim with the partial payment. At the conclusion of the trial, 75 days after the insurer tendered payment of $145,460, the insured was awarded damages for the roof totaling $179,000, a $33,540 difference. Therefore, the Texas Supreme Court held

that the insured was entitled to the statutory 18% per annum delay penalty only on the $33,540 difference between the tendered payment and the claim amount, as determined by the trial court.

Proving Your Insurer Failed to Meet Prompt Payment Deadlines Demonstrates an Unfair Settlement Practice Under Section 541:

At least one Texas court has concluded that in addition to the statutory penalties provided by 542.060, the failure to comply with Section 542's imposed deadlines is also the basis for a cause of action under Section 541 for the engagement of unfair settlement practices. See *Colonial County Mut. Ins. Co. v. Valdez*, 30 S.W.3d 514, 522023 (Tex. App. – Corpus Christi 2000, no pet.).

Thus, in addition to the statutory 18% penalty for violation of Section 542, the policyholder has the opportunity to recover its actual damages, policy benefits, attorney's fess and potential treble damages under the DTPA.

VI. UNDERSTANDING THE RIGHT TO INDEPENDENT COUNSEL

As a general rule, most insurance policies contain language that allow the insurance carrier to direct the defense of any litigation upon which it has a duty to defend its insured. Under such provision, the carrier can select the defense counsel, usually from a panel of law firms already approved by the carrier. Moreover, the insurance carrier generally is entitled to receive regular reports from the appointed counsel regarding the status and direction of the litigation.

However, the Texas Supreme Court addressed the issue of an insured's right to choose its own independent counsel when the carrier has sent a reservation of rights letter. In *Northern County Mutual Ins. Co. v. Davalos*, 140 S.W.3d 685 (Tex. 2004), a dispute arose between the carrier and insured due to the fact that the insured demanded that the carrier allow him to select his own counsel. The insured proceeded with his own counsel, despite the offer from the carrier to provide a defense – assigned to its panel counsel. Following the settlement of the lawsuit, Davalos filed a lawsuit against his carrier seeking the costs of suit and his attorney's fees.

The Texas Supreme Court rejected the Davalos' position and determined that since the carrier offered a defense without a reservation of rights, the carrier had the right to direct the defense and select its own defense counsel.

The *Davalos* decision went much farther than resolving that coverage dispute. The language used by the Court indicated that a conflict of interest will prevent the insurer from directing the defense when it provides a defense pursuant to a reservation of rights. The Court also concluded that if the defense would be inadequate or conditioned on an unreasonable extra-contractual demand that threatens the insured's independent legal rights, the carrier loses the right to control the defense.

This concept of independent counsel has been applied since the *Davalos* decision. In *The Housing Authority of the City of Dallas, Texas v. Northland Ins. Co.*, 333 F.Supp.2d 595 (N.D. Tex. 2004), the insured was sued as a result of alleged unlawful employment practices. The carrier agreed to provide a defense pursuant to a reservation of rights. Based upon the *Davalos* decision,

the *Northland* court determined that there was an irreconcilable conflict of interest which allowed the insured to reject the reserved defense and required the carrier to pay for counsel selected by the insured. The court noted that the underlying lawsuit specifically alleged that the conduct was willful and therefore the facts to be adjudicated in the underlying lawsuit were the same facts upon which coverage depended.

Consequently, each insured, upon receipt of a reservation of rights from the carrier, has the right to demand that it be allowed to select an independent counsel to direct the defense of the litigation.

VII. THE STOWERS DOCTRINE

G.A. Stowers Furniture Co. v. American Indemnity Co., 15 S.W.2d 544 (Tex.Comm'n.App. 1929, holding approved) is the landmark Texas case imposing a duty on an insurer to exercise reasonable care on behalf of the insured. The *Stowers* case first recognized that the insurer had a duty to exercise ordinary care in the handling of a suit filed by a third-party plaintiff. These duties became known as the "*Stowers* Doctrine."

The *Stowers* Doctrine essentially holds that when a policyholder is subjected to a third party lawsuit, the insurance carrier has a duty to settle within the insured's policy limits when an offer to settle a claim within the policy limits is tendered to the carrier.

The *Stowers* doctrine has been a powerful tool for insureds as it imposes a duty on the carrier to settle claims within the policy limits. If a carrier receives a proper *Stowers* demand and fails to settle the claim within the insured's policy limits then the *Stowers* doctrine holds that the insurance carrier would be responsible for indemnity for any judgment taken against the insured that would be in excess of the policy limits.

Consequently, the *Stowers* doctrine protects insureds from insurance carriers' refusal to settle claims and later subjecting the insured to a judgment that exceeded the insured's policy limits.

The Requirements for a Valid Stowers *Demand:*

In order for the *Stowers* doctrine to be triggered, a valid *Stowers* demand must be tendered to the carrier. The Texas courts have set parameters on what constitutes a valid *Stowers* demand.

First, in order to successfully invoke the *Stowers* Doctrine, the settlement demand on the insurance carrier must be within policy limits. *Westchester Fire Insurance Company v. American Contractors Insurance Company Risk Retention Group*, 1 S.W.3d 872 (Tex.App.—Houston [1st Dist.] 1999, no pet.).

Second, in order to trigger the *Stowers* doctrine, a settlement offer must be in writing. *Trinity Universal Insurance Company v. Bleeker,* 966 S.W.2d 489 (Tex. 1998).

Third, in addition to being within policy limits, and in writing, the offer must be unconditional in order to trigger *Stowers*. *Insurance Corp. of America v. Webster*, 906 S.W.2d 77 (Tex.App.—Houston [1st Dist.] 1995, no writ).

Last, in order for the *Stowers* demand to be valid, the demand must

include a full and final release of any and all claims, including an indemnification of any subrogation liens that could be held against the settlement proceeds. *Nationwide Mutual Insurance v. Chaney*, 2002 WL 31178068 (N.D. Tex. Sept. 30, 2002).

When the Carrier Breaches the Stowers *Doctrine:*

In the event that there has been a policy limits demand that was rejected by the insurance carrier, the insured has a cause of action against insurer for breach of its *Stowers* obligations. In addition to establishing the elements of a valid *Stowers* demand listed above, the policyholder must also establish the following elements:

1) The claim must be within the scope of the insurance coverage; and

2) The terms of the demand must be such that an ordinarily prudent insurer would accept it, considering the likelihood and degree of the insured's potential exposure to an excess judgment.

See *American Physicians Insurance Exchange v. Garcia,* 876 S.W.2d 842 (Tex. 1994).

Obviously, the last prong is the one that could create a hurdle for the insured to establish a violation of the *Stowers* doctrine. This prong has been referred to as the "reasonableness" standard as it requires the insured to prove that the insurer's rejection of the claim, despite the presence of a policy limits demand, was unreasonable. *St. Paul Fire and Marine Insurance Company v. Convalescent Services, Inc.*, 193 F.3d 340 (5th Cir. 1999).

VIII. CONCLUSION

Insurance law is an extremely complex and dynamic field of jurisprudence. This paper was designed to provide a general outline of insured's rights when facing a coverage dispute with its insurance carrier. Needless to say, the multitude of issues that face a general contractor or subcontractor when presented with a coverage dispute cannot be all addressed here.

However, considering our society's continued fascination with litigation, a company's insurance coverage is more important than ever before. As such, it is important for any business entity to understand its rights in the event of a coverage dispute. Moreover, it is equally important to understand the steps that an insured needs to take upon presentation of a claim to preserve those rights. In addition, an understanding of the various policy exclusions that exist in business risk policies and commercial general liability policies is helpful for insureds to understand where potential coverage disputes could arise and possibly reform business practices to prevent coverage disputes before they arise.

However, the most important element in preventing a coverage dispute is keeping adequate lines of communication open with your insurance agent, broker and carrier. Remember that a business relationship exists between the carrier and your company and it is probably in everyone's best interest for that relationship to continue. Thus, when your carrier requests documentation supporting your claim for a defense or indemnity, cooperate to the best of your ability and seek to avoid the coverage dispute altogether.