TADC INSURANCE LAW UPDATE

Fall 2013

David A. Clark
Brian T. Bagley
Scott R. Davis
Kent L. Harkness
Robert L. Horn
Kelly H. Leonard
Kristen W. McDanald
Meagan P. Wilder

Beirne, Maynard & Parsons, L.L.P.
Houston, Texas

This newsletter is intended to summarize significant cases impacting the insurance practice since the Spring 2013 newsletter. It is not a comprehensive digest of every case involving insurance issues during this period or of every holding in the cases discussed. This newsletter was not compiled for the purpose of offering legal advice. Any opinions expressed herein are those of the authors and do not necessarily reflect the views of Beirne, Maynard & Parsons, L.L.P.

ADDITIONAL INSURED: DEEPWATER HORIZON UPDATE

***In re Deepwater Horizon,* 710 F.3d 338 (5th Cir. 2013).**

In our Spring 2013 Update, we discussed the Fifth Circuit's holding in *In re Deepwater Horizon*. Since that update, the Fifth Circuit has withdrawn its March 1, 2013 opinion and certified questions relevant to it to the Texas Supreme Court. On certified question from the U.S. Court of Appeals, Fifth Circuit, the Texas Supreme Court will answer: (1) whether *Evanston Insurance Co. v. ATOFINA Petrochemicals Inc.* compels a finding that BP P.L.C. and affiliates are covered for damages because umbrella policy language alone determines the extent of BP's coverage as an additional insured if, and so long as, the drilling contract's additional-insured and indemnity provisions are "separate and independent" and (2) whether, given the facts in this case, the doctrine that an insurance contract will be interpreted in the insured's favor if it can be reasonably interpreted in more than one way applies to decide the drilling contract's insurance-coverage provision under the *ATOFINA* case.

FAILURE TO OBTAIN INSURER'S CONSENT

***Lennar Corp. v. Markel American Ins. Co.*, -- S.W.3d --, 2013 WL 4492800 (Tex. Aug. 13, 2013).**

Texas Supreme Court holds: (1) insurer is responsible for the costs of insured's non-approved remediation activities when insurer suffered no prejudice; and (2) insurer is responsible for costs incurred to determine property damage, as well as to repair it, and costs to remediate damage that began before and continued after policy period.

Lennar and another homebuilder it bought built approximately 800 homes using an exterior insulation and finish system ("EIFS") on the outside of the homes. Lennar stopped installing EIFS in 1998. After problems with EIFS were exposed on the NBC television show *Dateline* in 1999, complaints from owners of Lennar-built homes poured in.

Lennar investigated and learned that the problems associated with EIFS were frequent and substantial. EIFS trapped water between the exterior shell of a house and the wood studs used to frame the home, resulting in rotting wood, structural damage, mold, mildew, and termite infestations. Property damage typically began six to twelve months after EIFS was installed, progressed more or less, depending on the proximity of water due to rain and yard irrigation, and continued until the EIFS was removed. Lennar decided not merely to address complaints as it received them, but to contact all its homeowners and offer to remove the EIFS and replace it with conventional stucco. Lennar began its remediation program in 1999 and finished in 2003. Almost all the homeowners accepted Lennar's offer of remediation.

Early in the process, Lennar notified its insurers that it would seek indemnification for the costs. The insurers refused to participate in Lennar's proactive, comprehensive efforts, preferring instead to wait and respond to homeowners' claims one by one. All the insurers denied coverage, and in 2000, Lennar sued.

After summary judgments were entered and settlements were reached, Lennar went to trial against Markel American Insurance Company. After the jury returned its verdict, the trial court entered judgment

awarding Lennar: (1) $2,965,114.16 for the damages found by the jury, less a $425,000 credit for settlements with other insurers, (2) $2,421,825.89 in attorney fees, and (3) $1,227,476.03 in prejudgment interest.

The court of appeals reversed and rendered judgment for Markel on two grounds: (1) Lennar had not established its legal liability to the homeowners because, among other things, the settlements with homeowners' relied upon by Lennar, to which Markel had not agreed, failed to establish such liability under the policy (which required Markel's consent); and (2) Lennar had not offered evidence of damages covered by the policy, as the policy only covered cost of repairing home damage, not the cost of locating it, and Lennar failed to segregate the two.

The Texas Supreme Court reversed the court of appeals, and affirmed the judgment of the trial court. Addressing the holdings of the court of appeals in turn, the Texas Supreme Court first held that Lennar was permitted to rely upon its non-approved settlements with homeowners to establish legal liability, as the jury found that Markel had not been prejudiced. Markel's argument that Lennar's active solicitation of claims that otherwise never may have been brought by homeowners, thereby creating prejudice, was unpersuasive to the court. The court held this was a question of fact resolved by the jury in Lennar's favor. The court then held that, despite Markel's argument to the contrary, the Loss Establishment Provision in the policy, which included consent-to-settlement language, also required a showing of prejudice to Markel, which the jury did not find. The court then concluded that absent prejudice, settlements with homeowners established both Lennar's legal liability and the basis for determining the amount of the loss.

Turning to the issue of whether the amount of damages found by the jury was covered by the Markel policy, the court held that Markel was responsible for costs incurred to determine property damage as well as to repair it, ***and*** costs to remediate damage that began before and continued after policy period. The court explained that the cost to determine property damage was essential to the repair, and further noted that Markel conceded that each of the homes for which Lennar sought to recover remediation costs was actually damaged. As to alleged damages that began before or continued after the policy period, the court explained that there was no dispute that the property damage complained of, which was a progressive damage caused by trapped water, either began or worsened during the policy period. Therefore, such damage was part of the "total amount" of loss contemplated by the Markel policy.

FAILURE TO REPORT LOSS: PREJUDICE NOT REQUIRED

***Starr Indemnity & Liability Company v. SGS Petroleum Service Corporation*, 719 F.3d 700 (5th Cir. 2013).**

Insurer not required to show prejudice before denying coverage for liability arising out of untimely reported pollution occurrence.

An insurer issued an excess umbrella policy to an insured. Although the policy had an absolute pollution exclusion precluding coverage for the consequences of the release of chemicals, the parties added a pollution "buy-back" provision, which deleted the exclusion and replaced it with a new provision providing coverage for a release of chemicals reported "within 30 days after having been known to the assured." An accidental release of a chemicals occurred, and the insured reported it to the insurer 59 days later.

The insurer moved for a judgment on the pleadings contending that the policy did not cover the insured's claims because the insured had failed to notify it of the chemical release within 30 days. The insured moved for summary judgment alleging, in part, that failure to comply with the notice requirement did not excuse the insurer's performance absent prejudice to the insurer. The district court granted the insurer's motion for judgment on the pleadings and denied the insured's motion for summary judgment. The insured appealed.

The Fifth Circuit affirmed, recognizing that it was bound by its decision in *Matador Petroleum Corp. v. St. Paul Surplus Lines Ins. Co.*, 174 F.3d 653 (5th Cir. 1999), where it had held that prejudice to the insurer as a result of late notice was irrelevant because the policy must be enforced according to its terms. Relying on *Matador*, the court reasoned that the plain language of the endorsement should be respected regardless of any prejudice suffered by the insurer as a result of late notice. It held that the insurer was justified in denying coverage under the clear terms of the buy-back provision. The court also noted that the current case was distinguishable from Texas Supreme court precedent requiring a showing of prejudice to the insurer, as the notice provision at issue was an essential part of the bargained-for exchange, and had

been specifically negotiated by sophisticated commercial parties to replace the original pollution exclusion.

SOPHISTICATED INSURED EXCEPTION

Certain Underwriters at Lloyds of London v. Stanford, et. al., **No. 3:09-CV-2206-N (2013).**

The sophisticated insured exception to the general rule that ambiguous policy language is to be construed against the insurer is limited to the portions of the policy that are the subject of negotiation and does not apply to standard forms drafted by the carrier.

This coverage action arose out of the criminal prosecution of officers of Stanford Financial Group Company, one of the entities controlled by R. Allen Stanford that was involved in what the court characterized as the "Stanford Ponzi scheme." Significantly, the SEC initiated a civil action against Stanford and various of his entities and associates in 2009. The federal district court appointed a receiver that took control of Stanford's assets (the "Receivership Order"). These particular defendants were indicted for various criminal charges arising out of the shredding of Stanford documents. They were acquitted.

The issue in the coverage case was whether Underwriters were obligated to pay defense costs incurred in connection with the criminal prosecution under an excess D&O policy. The court characterized the single legal issue presented as follows: "Does the Receivership Order trigger the change of control exclusion in the D&O Policy?"

The change in control exclusion provided as follows: "The Underwriters shall not be liable to make any payment for Loss resulting from any Claim based upon, arising out of, directly or indirectly resulting from or in consequence of, or in any way involving, any Wrongful Act occurring subsequent to the time tha the earliest of the following events take place: (1) Another entity or individual holds a majority of the voting rights in the Parent Company."

Underwriters argued that the sophisticated insured exception recognized in *Balandran v. Safeco Ins. Co. of Am.*, 972 S.W.2d 738 (Tex. 1998), should apply such that the exclusion not be construed against them. In rejecting this argument, the court predicted that "Texas courts would limit the exception to, at most, those portions of the policy that were the subject of negotiation, and not apply it to those portions of the policy that were standard form, drafted and imposed by the carrier." Since there was no evidence that the insured participated in the negotiation of the exclusion, the court held that the sophisticated insured exception did not apply.

The court went on to find that the exclusion was ambiguous in that one reasonable reading of the exclusion was that an equitable receiver such as the one appointed in this case stood in the shoes of R. Allen Stanford and, therefore, was not "another entity or individual." Therefore, the exclusion was inapplicable and the individual insureds were entitled to summary judgment.

INSURED CANNOT CONVERT D&O POLICY INTO A FIRST-PARTY POLICY

American Construction Benefits Group, LLC v. Zurich American Ins. Co., **C.A. No. 3:12-CV-2726-D (N.D. Tex. 2013).**

A D&O liability policy does not cover the insured's own loss.

American Construction Benefits Group (ACBG") provided health insurance to J.D. Abrams, one of its member companies. ACBG obtained reinsurance from Presidio Excess Insurance Services. ACBG's president accepted an exclusion from Presidio for the cost to cover a heart transplant for the child of an Abrams employee. ACBG still had to cover the $1.2 million cost of the transplant, but had no reinsurance to cover this loss.

ACBG made a claim against Zurich under a D&O policy that covered claims made against ACBG for wrongful acts committed by an officer or director of ACBG. ACBG contended that its president's acceptance of the exclusion from Presidio was a Wrongful Act that caused its loss.

The court granted Zurich's motion to dismiss because, even assuming that the president's acceptance of the exclusion from Presidio was a Wrongful Act, that act did not cause J.D. Abrams' loss. ACBG was obligated contractually to pay the cost of the transplant regardless of the actions of ACBG's president or whether ACBG had reinsurance.

Although the president's actions may have caused loss to ACBG, Abrams' claim against ACBG had nothing to do with the president's actions. In granting Zurich's motion to dismiss, the court adopted Zurich's contention that ACBG was "attempting to transform its D&O *liability* policy into a first-party policy to provide coverage for its own loss."

CHOICE OF LAW CLAUSE

***Preferred Contractors Ins. Co. Risk Retention Group, LLC v. Oyoque Masonry, Inc.*, No. 4:12-CV-1406, 2013 WL 3899332 (S.D. Tex. July 26, 2013).**

Choice of law provision trumped by Texas Insurance Code's deference to Texas law.

The trial court granted summary judgment in favor of Plaintiff Preferred Contractors Insurance Company Risk Retention Group, LLC ("PCIC"), denying defense and indemnity coverage on the basis of an exclusion in the policy for claims by any persons affiliated with contractors or volunteer workers.

In entering summary judgment, the court held that although the duty to indemnify is based on actual facts established in the underlying suit, in addition to policy terms and conditions, the duty to indemnify is justiciable before the insured's liability is determined when the insurer has no duty to defend. In sum, the same reasons that negate the duty to defend likewise negate any possibility the insurer will ever have a duty to indemnify. Here, where the claim against the insured was made by a person categorized (despite the insured's best efforts to re-interpret his role as a subcontractor, temporary worker, or volunteer worker) as a person affiliated with an independent contractor, coverage could not exist.

Perhaps the highlight of the case, however, lies in the Southern District's choice of law analysis. The Defendants pointed to a choice of law provision in the policy stating that the policy is to be governed and construed in accordance with Montana law. However, the court found that the Texas Insurance Code Section 21.42 provides that "[a]ny contract of insurance payable to any citizen or inhabitant of this State by any insurance company or corporation doing business within this State shall be held to be a contract made and entered into under and by virtue of the laws of this State relating to insurance, *and governed thereby*." (emphasis added in case, but does not exist in statute). The court stated that since PCIC does business in Texas and the insured is a Texas corporation, Texas law "plainly controls."

The court also noted, however, that application of Montana law would almost certainly lead to the same result. So it is unclear whether the Houston Division would so easily ignore a policy's choice of law provision if that were not the case.

UM COVERAGE

***Noteboom v. Farmers Texas County Mutual Ins. Co.*, No. 02-12-00441-CV, 2013 WL 3470555 (Tex.App.—Fort Worth July 11, 2013).**

Diminished value is not recoverable under Texas's form collision coverage, but may be covered under uninsured motorist coverage.

After a car accident with an uninsured motorist ("UM"), the insured claimed that her vehicle diminished in value by $8,000 after repairs. Farmers had paid for the vehicle repairs, but only offered $2,700 for the car's diminished value. The insured rejected the offer, and this coverage action ensued. The parties stipulated in the coverage action that the diminished value was $8,000, and further stipulated that the sole issue for the trial court was "whether or not the diminution in value is recoverable under the policy." Farmers took the position that the diminished value of a car is not recoverable under the standard Auto Policy, generally, nor recoverable under the specific policy at issue.

Although the court agreed with Farmers that the auto policy's collision coverage would not cover damages for a reduction in value after covered repairs were made, the court found that the insured had the right under the policy to choose which coverage to elect where both collision and UM coverage may apply. This right was granted within the policy itself, and is codified in the Insurance Code.

The UM coverage stated that Farmers "will pay damages which a covered person is legally entitled to recover from the owner or operator of an uninsured motor vehicle because of … property damage, caused by an accident." Farmers argued that recovery of cost of repair and damages for diminished value would amount to a double recovery. The court disagreed, stating that the costs are "[n]ot duplicative if the diminished value is calculated based on a comparison of the original value of the property and the property's post-repair value." Thus, the court granted recovery for the insured.

RIPENESS

***Triyar Companies, LLC v. Lexington Ins. Co.*, No. 3:12-CV-294, 2013 WL 3280033 (S.D. Tex. June 27, 2013).**

Ripeness of declaratory judgment action may be determined by whether the damage-causing event has occurred, not whether the amount of damages has been fixed.

Triyar Companies, LLC ("Triyar") sought a declaration that one of its insurers, Defendant Lexington Insurance Company, was liable for alleged hailstorm damage to Triyar's property, and that Lexington would breach the insurance policy and its duty of good faith and fair dealing if it did not promptly pay Triyar's claim. Lexington moved to dismiss on the following grounds: (1) it was still investigating Triyar's claim, (2) Triyar had not submitted a proof of loss, and (3) Lexington had not officially denied Triyar's claim. Thus, Lexington argued there was not a ripe, justiciable controversy between the parties. The court held that Triyar's request for a declaration that it was entitled to coverage under the policy was ripe; but found that Triyar's request for a declaration that Lexington would commit a breach of contract and a breach of its duty of good faith if Lexington did not promptly pay Triyar's claim, was not.

In its analysis, the court noted that whether a claim is ripe for adjudication requires key considerations including "the fitness of the issues for judicial decision and the hardship to the parties of withholding court consideration." The fitness consideration asks whether the issues at stake are purely legal or whether the further factual development is necessary to resolve the case. The hardship inquiry examines the difficulty the parties will face if the judicial decision is denied.

In considering the fitness of the coverage issue for judicial decision, the court stated that because the damage-causing-event (the hailstorm) had already happened, whether the damages caused by the hailstorm were covered under the policy could be determined. The fact that the amount of damages sustained due to the storm had not yet been fixed was found immaterial to the liability consideration, generally. Regarding hardship, because Triyar had waited until two years after the storm to file the suit, limitations concerns arose.

Turning to Triyar's claims regarding future breach of contract or future breach of the duty of good faith and fair dealing, the court found the claims not yet ripe because Lexington had not breached any of its contractual or extra-contractual duties to date.

YOUR WORK AND EARTH MOVEMENT EXCLUSIONS

***Mid-Continent Casualty Co. v. Krolcyzk*, No. 01-12-00587-CV, 2013 WL 2445049 (Tex.App.—Houston [1st Dist.] June 6, 2013) (Opinion withdrawn and superseded on denial of rehearing by *Mid-Continent Casualty Co. v. Krolczyk*, No. 01-12-00587-CV, 2013 WL 4189696 (Tex.App.—Houston [1st Dist.] Aug. 15, 2013, no pet. h).**

Krolcyzk owned a tract of land in Waller County which he subdivided and sold to purchasers for home sites. In a subsequent suit, the purchasers alleged the roads Krolcyzk laid were defective, and Krolcyzk sought coverage under his CGL policy issued by Mid-Continent. Mid-Continent denied its duty to defend Krolcyzk under the CGL's "your work" and "earth movement" exclusions. Both parties sought summary judgment, which were denied. This interlocutory appeal ensued.

The court of appeals reviewed the policy exclusions and found the "your work" exclusion applied in part, and the "earth movement" exclusion did not apply.

The roadway at issue was laid in three severable phases. Only one phase (the first) was completed improperly. Because the "your work" exclusion did not operate to exclude damages to all severable parts of the roadway, the "your work" exclusion did not obviate the duty to defend.

The "your work" exclusion at issue provided that the CGL coverage did not apply to:

> "Property damage" to: …
>
> (6) that particular part of any property that must be restored, repaired or replaced because "your work" was incorrectly performed on it.

"Your work" was defined, in relevant part, as "Work or operations performed by you or on your behalf." The court noted that while the "your work" exclusion is a business-risk exclusion, and its purpose is to preclude coverage for damage to an insured's own

work, the actual coverage for the type of risk depends on the policy's specific language.

The court further stated that under the "your work" exclusion, liability coverage is excluded only when two requirements are met: (1) the property damage is to "[t]hat particular part" that must be restored, repaired, or replaced; and (2) a result of the insured incorrect work on that particular part. With this backdrop, the court stated that an exclusion that unambiguously precludes coverage for *all* property damage caused by the defective work of the insured should omit the limiting language referencing a "particular part of any property," and state: "Property damage to property that must be restored, repaired or replaced because your work was incorrectly performed on any part of it."

As such, the exclusion here only precluded coverage for repairing or replacing the insured's defective work; "it [did] not exclude coverage for damage to other property resulting from the defective work."

Applying the standard to the relevant facts, the appellate court stated that the relevant allegation to the duty to defend was that the road was built in three phases. In the first phase Krolcyk built drainage ditches and the base of the whole road, and laid asphalt to surface of the first section (1/3) of the road length. Eighteen months later, he laid asphalt for the second section of the road length, but he did not rework the road base. Finally, "after extended exposure to the elements," he surfaced the remaining length of the road, but again he did not rework the base. The plaintiffs alleged that the drainage alongside the road was "not adequate to prevent rain water from washing out some of the base." The road base allegedly "failed" as a result of Krolcyk's failure to rework the base or construct adequate drainage, and this failure allegedly "caused the asphalt surface to crack and pothole after less than one year of use." The road was rendered useless and unable to meet the standards of Waller County—not because of the way the asphalt was laid, and not because of the way the asphalt was surfaced, but because of the way the *road base* was constructed (i.e., during the first phase of construction).

The court found that because the roadway construction was severable into three parts, and the only part on which faulty work was performed was the road base, the "your work" exclusion would only exclude the damages to the road base. Thus, the laying of the roadway and surfacing work, which were not alleged to have been improperly performed, could be covered damages, and the "your work" exclusion did not bar the duty to defend allegations having to do with damages to those severable parts.

Next, the court considered the "earth movement" exclusion, which stated:

> "This insurance does not apply to … "property damage" … arising out of, caused by, resulting from, contributed to, aggravated by, or related to earthquake, landslide, mudflow, subsidence, settling, slipping, falling away, shrinking, expansion, caving in, shifting, eroding, rising, tilting or any other movement of land, earth or mud.

In analyzing the applicability of the exclusion, the court noted that the allegations in the pleadings did not state facts sufficient to clearly bring the case in or out of coverage. The court held that when allegations in pleadings do not clearly allege facts outside of coverage, an insurer is obligated to defend.

EXHAUSTED LIMITS: NO HARM, NO FOUL

***Sebring Apartment, el al., v. Lexington Insurance Company, et al.*, 4:10-cv-00019 (S.D. Tex., July 31, 2013).**

Insured has no basis to bring a claim against its insurer after insurer has exhausted the policy limits.

Nordling Property sued Lexington Insurance Company for breach of contract and bad faith, claiming Lexington failed to promptly pay its claim for property damage caused by Hurricane Ike. Nordling sought recovery of its attorneys' fees and 18% interest. Lexington had exhausted its policy limits by the time of the lawsuit.

The court held that Lexington did not breach its contract with Nordling because Lexington had exhausted the policy limits. Nordling was not entitled to recover its attorneys' fees or 18% interest without proving a breach of contract claim. Lexington had made a good faith attempt to pay the claims, as evidenced by the fact that it exhausted the policy limits by paying the maximum amount it could have owed for that layer of coverage. Nordling was not entitled to recover its attorney's fees or interest because it was owed nothing under the contract – as the court aptly noted, "18% of zero is zero."

NEWLY ACQUIRED ENTITY EXCLUSION

***Brit UW Limited v. Monica Briones, et al.*, 5:11-cv-00994-DAE (W.D. Tex., June 25, 2013).**

Unnamed entities not insured under CGL policy that excludes coverage for entities not listed as a named insured.

Insurer issued commercial general liability policy to "Kicaster Korner Bar," a sole proprietorship wholly owned by Ricardo Briones, Jr. In April 2008, Briones completed a "Tavern PDQ Supplemental Application" listing the insured as "Ricardo Briones, Jr., Kicaster Korner Bar." One month later, a commercial insurance application listed the named insured as "Kicaster Korner Bar," an "individual." The policy named "Kicaster Korner Bar" as the insured on the declarations page and designated the insured as an "individual."

The policy provided that if an insured is an "individual," the individual's spouse and "legal representative if you die" is also an insured. But the policy also precluded coverage for newly acquired entities, and provided, "[n]o person or organization is an insured . . . that is not shown as a named insured in the declarations."

In 2008, Briones's brother was killed on the premises of Kicaster Korner Bar. At the time of Briones's brother's death, Kicaster Korner Bar was still a sole proprietorship. Subsequently, Briones died and his wife became the administrator of the estate, and Kicaster Korner Bar, LLC was formed. The deceased brother's widow then sued "Kicaster Korner Bar," described as "a Texas Corporation," for the death of her husband. The widow received a default judgment for $5 million. Briones's estate made a claim under the policy based on the default judgment. The insurer denied coverage because the named defendant was not named as an insured under the policy.

The insurer sued for a declaration of rights under the Policy. It then moved for summary judgment, asking the court to declare, among other things, that "Kicaster Korner Bar, a Texas Corporation" was not insured under the policy.

The district court granted the insurer's motion for summary judgment. It held Ricardo Briones, Jr., as the sole proprietor, was insured under the policy and that, following his death, his widow became an "insured" in her capacity as administrator of his estate. Yet, the court held that the policy excluded coverage for successor entities because the provision made clear that the policy did not insure any unnamed entity and an endorsement removed coverage for newly acquired entities. Accordingly, the successor entity, Kicaster Korner Bar & Grill, LLC, as a separate entity from Kicaster Korner Bar, the sole proprietorship, was not a named insured under the policy.

CAUSES OF LOSS EXCLUSION

***Lexington Ins. Co. v. JAW The Pointe, LLC*, No. 14-11-00881-CV, 2013 WL 3968445 (Tex. App.—Houston [14th Dist.] Aug. 1, 2013, pet. filed).**

Losses attributable to demolition and repair under "Ordinance or Law Coverage" and "Demolition and Increased Cost of Construction" endorsements must spring from covered claims, and insured's claim for demolition and reconstruction due to a combination of flood and wind damage was not covered under either endorsement when the policy unambiguously excluded from coverage damages caused in whole or in part by flooding.

A Galveston apartment complex, The Pointe, secured insurance coverage from Lexington and other insurance companies under a group program that provided coverage to hundreds of unrelated apartment complexes in multiple states. The group plan consisted of several layers of coverage totaling $100 million. Lexington provided $25 million in coverage as the primary layer of insurance. Lexington's policy provided coverage for property damage and physical losses, but excluded coverage to losses listed on an Endorsement entitled "Causes of Loss—Special Form." The exclusion stated:

> We will not pay for loss or damage caused directly or indirectly by any of the following. Such loss or damage is excluded regardless of any other causes of event that contributes concurrently or in any sequences to the loss.
>
> a. Ordinance or Law
>
> The enforcement of any ordinance or law:
>
> 1) Regulating the construction, use or repair of any property; or

2) Requiring the tearing down of any property, including the cost of removing debris.

g. Water

1) Flood….

Lexington's insuring agreement also contained two endorsements under which an insured might recover for demolition and rebuilding costs resulting from an obligation to comply with ordinances: an "Ordinance or Law Coverage," and a "Demolition and Increased Cost of Construction" endorsement.

The Pointe was damaged after Hurricane Ike hit Galveston in 2008. It sought coverage for the damage from Lexington. The Pointe and Lexington appointed adjusters to resolve the claim. The adjusters did not have authority to make coverage decisions, but were charged with assessing damage to the property. Lexington's adjuster ultimately estimated that wind damage totaled $1,278,000 and the damage from flood totaled $3.5 million. The Pointe asked Lexington for payment of "the whole loss and damage" of $1,278,001.33 minus their deductible, and Lexington paid The Pointe the requested amount.

While The Pointe initially intended to repair the complex, the City of Galveston inspected the complex, determined it was "substantially damaged," and mandated that the apartment complex be rebuilt to be brought into compliance with local flood damage regulations, including requirements that the building be elevated eleven feet above ground. As a result of this determination, The Pointe demolished its apartment complex and began to rebuild it.

Meanwhile, the parties had not discussed the remainder of The Pointe's insurance claim (beyond the amounts attributable to covered wind damage). The sole conversation concerning The Pointe's outstanding claims occurred during a telephone call between the adjusters in which Lexington's insurance adjuster stated Lexington had determined that The Pointe's claim was not covered because Lexington believed all damages, including the costs to rebuild the complex to comply with code requirements, were the result of uncovered flood damage.

The Pointe sued Lexington for claims arising from Lexington's adjustment and claims process. It alleged claims for breach of contract, violations of the Texas Insurance Code, violations of the DTPA and bad faith against Lexington.

After The Pointe filed suit, Lexington sent The Pointe a letter explaining that flood damage was not covered under the policy, and it would not provide coverage to The Pointe under the "Ordinance or Law Coverage" or "Demolition and Increased Cost of Construction" endorsements. Lexington further explained that its $25 million primary policy had been exhausted by payments made to other group members; therefore, it had no further obligations to The Pointe for damages.

At trial, Lexington moved for partial summary judgment on the grounds that The Pointe's breach of contract claim failed as a matter of law because Lexington had paid policy limits. Lexington also moved for summary judgment on the grounds that The Pointe's claim for flood coverage should be dismissed because flood coverage was unambiguously excluded from coverage. The trial court granted Lexington partial summary judgment and the remaining claims proceeded to trial.

A jury found Lexington had engaged in unfair or deceptive acts by failing to attempt in good faith to effectuate a prompt settlement of The Pointe's claims, failing to promptly provide an explanation for denying claims, and failing to affirm or deny coverage within a reasonable time. The jury answered "No" when asked whether Lexington refused to pay claims without conducting a reasonable investigation. The jury also answered "No" when asked whether Lexington received all items, statements, and forms reasonably requests to secure final payment of loss. Based on its findings, the jury awarded The Pointe damages for repair or replacement covered under the Policy's Ordinance and Demolition endorsements, reasonable attorneys' fees and damages for Lexington's "knowing" violation of the Insurance Code.

On appeal, Lexington argued the evidence was legally insufficient to support a finding it violated the Insurance Code. Primarily, Lexington claimed it could not be held liable because The Pointe's damages were not covered losses in the first instance and, as a general rule, Texas does not recognize a claim for bad faith when an insurer denies an uncovered claim. Lexington argued The Point's loss was not covered under the policy because it excluded flood damage, and the damage to The Pointe was caused in whole or in part by flooding. Lexington further argued the City's determination that The Pointe was "substantially damaged" did not establish coverage because the finding did not differentiate

between covered wind damage and excluded flood damage. The appellate court agreed with Lexington.

The appellate court explained Lexington's policy broadly excluded flood damage under the "Causes of Loss—Special Form," even when flood damage was mixed with covered losses. In other words, unsegregated losses from a combination of wind and flood were excluded under Lexington's policy. The court held that the Ordinance and Demolition endorsements did not change the broad flood exclusion in the "Causes of Loss-Special Form" because neither endorsement removed the flood exclusion. Instead, when read together with the "Causes of Loss—Special Form," the Ordinance and Demolition endorsement still required that an enforcement be caused by or result from a covered loss.

The court held legally insufficient evidence supported a finding that The Pointe's rebuilding efforts resulted from a covered loss under either the Ordinance or Law Coverage or Demolition and Increased Cost of Construction endorsements. The court explained that the City of Galveston had required The Pointe to reconstruct its complex in order to comply with flood regulations. The Pointe had submitted a building permit application for $6,256,887 in repairs to the City, but the application did not allocate between flood and wind damages. Nor did the City of Galveston find that The Pointe was "substantially damaged" based on a distinction between wind and flood damage. The City's "substantial damage" finding was instead based on its conclusion that the building had damage equaling or exceeding 50 percent of the structure's market value. Because the City did not allocate damages attributable to flood (an uncovered loss) from damages attributable to wind (a covered loss), The Pointe could not rely on the Ordinance or Law Coverage or Demolition and Increased Cost of Construction endorsements to cover its demolition and rebuilding costs.

After concluding The Pointe's damages were not covered by Lexington's insuring agreement, the court examined whether The Pointe could nonetheless maintain its bad faith claims. The Pointe argued it could pursue a claim for bad faith even though its damages were not covered because its bad faith claim arose out of a duty to timely investigate the claims. The court rejected this argument for two reasons. First, the supreme court "has not stated that an insurer's failure to timely investigate an insured's claim may constitute an actionable bad faith claim." Second, the jury's finding that Lexington had not refused to pay claims without conducting a reasonable investigation was not challenged.

Having held the Lexington could be not liable for bad faith because its policy did not cover The Pointe's losses, the court further concluded that the jury had no basis from which it could award "Policy benefits for repair or replacement of [The Pointe's] property due to damage to the property covered under the Demolition and Increased Cost of Construction endorsement or Law and Ordinance endorsement to [Lexington's] policy" or damages based on a "knowing" violation of the Insurance Code. Nor could the jury award attorneys' fees to The Pointe in the absence of any statutory violation. The court thus reversed the trial court's judgment and rendered a take nothing judgment against The Pointe.

MOTOR VEHICLE EXCLUSION

***Oleksy v. Farmers Ins. Exh.*, No. 01-11-00545-CV, 2013 WL 3894890 (Tex. App.—Houston [1st Dist.] Jul. 30, 2013, pet. filed).**

Insurer did not negate coverage under exception to motor vehicle exclusion in homeowners' insurance policy.

A homeowner sued his homeowner's insurance carrier for a declaration that the carrier, Farmers Insurance, had a duty to defend and indemnify him for a lawsuit arising from his operation of a snowmobile. Farmers' insuring agreement excluded personal injuries arising from the use of motor vehicles, but the homeowner claimed he met an exception to the exclusion which states: "This exclusion does not apply to (1) motor vehicles which are not subject to motor vehicle registration and are: . . . (d) designed and used for recreational purposes; and are (i) not owned by an insured; or (ii) owned by an insured while on the residence premises."

Farmers moved for summary judgment. Its motion purported to both establish the applicability of the exclusion and negate the exception to the exclusion because the snowmobile was subject to registration in New York and deposition testimony supported that the insured owned the snowmobile. The insured filed a cross-motion for summary judgment. He argued that the question of whether the snowmobile was subject to motor vehicle registration had to be decided under Texas law pursuant to Article 21.42 of the Texas Insurance Code. He also disputed ownership of the snowmobile. The trial court granted summary judgment in favor of Farmers, denied the insured's motion, and issued a final declaratory

judgment that the insurance policy did not cover the snowmobile accident and Farmers had no duty to defend or indemnify its insured in a lawsuit arising from its use.

After the court signed its final judgment, the plaintiff in the underlying lawsuit amended his petition to state that Farmers' insured did not own the snowmobile. Rather, it was owned by another party. The insured moved for a new trial in the coverage case against Farmers, citing the underlying plaintiffs' amended petition. The trial court overruled the motion for new trial, and the insured appealed.

On appeal, the insured argued the trial court had erred in entering summary judgment based on the exception to the motor-vehicle exclusion. Because Farmers conceded on appeal that its insured did not own the snowmobile, the issue was whether the snowmobile was subject to a registration requirement. Initially, the insured argued a conflict between New York and Texas law existed, requiring the court to apply Texas law. The court of appeals found there was no conflict of law with respect to a snowmobile registration requirement—neither New York or Texas law subjects snowmobiles to a motor vehicle registration. In light of its conclusion that snowmobiles are not subject to motor vehicle registration under New York or Texas law, the court held Farmers did not conclusively disprove the exception to the motor-vehicle exclusion.

The Court then turned its attention to whether the homeowner had carried his summary judgment burden to establish the exception to the exclusion, thereby entitling him to summary judgment on his competing motion for coverage. The court concluded he did not. The homeowner relied entirely on Texas law in his summary judgment motion; he did not argue that the New York Vehicle & Traffic Laws established as a matter of law that snowmobiles are not subject to motor-vehicle registration. The court of appeals therefore declined to consider the homeowners' appellate arguments concerning New York law. The court concluded the trial court erred in granting Farmers' motion for summary judgment and did not err in denying the homeowner's motion for summary judgment. It reversed the judgment of the trial court and remanded the case for further proceedings.

BLOWOUT ENDORSEMENT EXPANDS COVERAGE

***Century Surety Co. v. John Deloach d/b/a Deloach Vacuum Serv.*, No. 13-12-00072-CV, 2013 WL 41006702 (Tex. App.—Corpus Christi Aug. 1, 2013, no pet. h.) appeal dismissed by agreement, 2013 WL 552066 (Tex. App.—Corpus Christi Oct. 1, 2013).**

Blowout Endorsement to CGL Policy expanded coverage and superseded the application of the policy's Total Pollution Exclusion and Oil and Gas Endorsement.

Deloach owned and operated a waste disposal well in the Hull Salt Dome. Deloach purchased CGL coverage for its operations from Century. During the coverage period, a sinkhole formed where Deloach performed its operations and four lawsuits were filed against it. The first case alleged the "underground pressure created by the collapse at the sinkhole site caused an abandoned, unplugged oil well . . . to explode and it flowed thousands of deleterious substances across [the plaintiffs'] property." The plaintiffs cited damages including loss of vegetation, diminution of market value and loss of the aesthetic value of the property. The plaintiffs in the second case alleged that the substances and chemicals injected by Deloach penetrated groundwater and thereby prevented the enjoyment and use of the property to such a degree that it had become practically worthless. The plaintiffs also sought to recover for the trespass of the encroaching contaminates. In the final two cases, the plaintiffs alleged Deloach caused a sinkhole and water contamination as a result of injecting toxic substances into the disposal well. Like the other plaintiffs, they sought to recover for loss of the use and enjoyment of property.

Deloach tendered the suits to Century for coverage under its policy. Like many CGL policies, the insuring agreement covered property damage defined as "physical injury to tangible property, including all resulting loss of use of the property." Century issued a reservation of rights letter to Deloach but ultimately denied coverage based on the application of two provisions: Total Pollution Exclusion and Oil and Gas Endorsement. The Pollution Exclusion stated the insurance did not apply to "property damage which would not have occurred in whole or in part but for the actual, alleged or threatened discharge, dispersal,

seepage, migration, release or escape of pollutants," which the policy defined as "any solid, liquid, gaseous, or thermal irritant or contaminant . . . ." The Oil and Gas Endorsement excluded "property damage which would not have occurred in whole or in part but for the movement of the earth or land, including by the extraction of underground wells."

Deloach sued for a declaration of its rights under the policy, arguing that the application of the Pollution Exclusion as a bar to coverage would render coverage provided under the policy's Blowout and Cratering Coverage Endorsement illusory, and that the Blowout Endorsement conflicted with and superseded the Pollution Exclusion. Deloach argued the Blowout Endorsement expanded coverage to it. The parties filed cross motions for summary judgment, and the trial court ruled in favor of Deloach, finding Century had a duty to defend and indemnify Deloach in the underlying lawsuits.

On appeal, Century argued it did not have a duty to defend based on the Pollution Exclusion and the Oil and Gas Endorsement. As it had in the trial court, Deloach argued the Blowout Endorsement conferred coverage because it expanded coverage.

The court of appeals concluded that the Blowout Endorsement expanded coverage to Deloach. In support, it cited the following language in the Blowout Endorsement: "the following provisions are added with respect to 'property damage' included within the 'blowout & cratering hazard' arising out of the operations performed by you or on your behalf." The court next considered whether the Pollution Exclusion conflicted with the Blowout Endorsement. It concluded the provisions conflicted with one another and that the Pollution Exclusion rendered the Blowout Endorsement meaningless because "an occurrence covered under the Blowout Endorsement could necessarily arise in the absence of pollution, which the Pollution Exclusion excludes from coverage." The court held that because there was a conflict between the two provisions, and it was required to construe the underlying lawsuits to trigger the duty to defend, the Blowout Endorsement superseded the Pollution Exclusion, and thus, Deloach was entitled to coverage based on the claims asserted against it.

The court held the Oil and Gas Endorsement similarly conflicted with the Blowout Endorsement. The court explained that the Oil and Gas Endorsement excluded property damage arising out of toxic or hazardous properties of minerals and other substances and that it would be unlikely that a blowout could occur in the absence of the release of "toxic or hazardous property of minerals or other substances." Finally, the court rejected Century's claims that coverage was excluded for the cases alleging groundwater damage. The court concluded that, although the Blowout Endorsement covered above-surface damages only, the plaintiffs had alleged both above-surface and below-surface damages, therefore entitling Deloach to a defense.

NAMED DRIVER EXCLUSION AFFECTS LOSS PAYABLE CLAUSE

***Stadium Auto, Inc. v. Loya Ins. Co.*, No. 08-11-00301-CV, 2013 WL 3214618 (Tex. App.—El Paso 2013, no pet.).**

Applying named driver exclusion to loss payable clause, court held financier of automobile purchase could not recover under auto policy's loss payable provisions.

Salazar purchased a standard auto policy from Loya covering her 2005 Ford Expedition. The policy included an exclusion of named driver endorsement listing Sanchez as an excluded driver. After Sanchez had an automotive accident while driving Salazar's car, Salazar stopped making financing payments on her Ford Expedition to Stadium Auto. Stadium made demand on Loya under the loss payable clause of the insurance policy. Loya refused to pay the claim, citing the policy's named driver exclusion, and Stadium sued Loya for violations of the Insurance Code and Texas Deceptive Trade Practices Act. Loya moved for summary judgment on the grounds that its policy did not provide coverage for damage occurring when the car was operated by a driver excluded under the policy. Stadium filed a counter-motion for summary judgment. The trial court denied Stadium's motion and granted summary judgment in favor of Loya. Stadium appealed.

The appeal focused on the construction of the policy's named driver exclusion and loss payable clause. The court of appeals concluded that the named driver exclusion, which broadly stated "[y]ou agree that none of the insurance coverages afforded by this policy shall apply while The Excluded Driver is operating your covered auto or any other motor vehicle," was unambiguous. The court of appeals further concluded that the summary judgment evidence proved that an excluded driver, Sanchez, was operating the covered automobile at the time of the accident, therefore triggering the excluded driver endorsement. The court next determined whether

Loya was nevertheless obligated to pay for the car's damage under the policy's loss payable clause because the lost payee, Stadium, enjoyed greater rights under the policy than the insured, Salazar. The court relied on First Court of Appeals precedent, *Old American Mut. Fire Ins. Co. v. Gulf States Finance Company*, 73 S.W.3d 394, 395-96 (Tex. App.—Houston [1st Dist.] 2002, pet. denied), to hold Stadium was not protected by the loss payable clause from any act or neglect of the insured, but only from the insured's fraudulent acts or omissions. Thus, Stadium lost coverage when the insured, Salazer, lost coverage by entrusting her car to another.

ANTI-TECHNICALITY PROVISION OF TEXAS INSURANCE CODE

***Mario Santacruz v. Allstate Texas Lloyds, Inc.*, Civil Action No. 3:12-CV-02553-BK (N.D. Tex. June 25, 2013).**

Anti-technicality provision applied to prevent insurer from denying coverage based on insured's immediate repair of roof, which denied insurer access to the damaged property.

Plaintiff, Mario Santacruz, made a claim under his homeowner's policy for the cost of repairing his roof and damage to certain personal property following a storm. Defendant, Allstate Texas Lloyds, denied coverage asserting that it was deprived of access to the damaged property and an opportunity to investigate the claimed loss because Santacruz had the entire roof repaired immediately following the storm. Santacruz then filed suit asserting claims for breach of the duty of good faith and fair dealing and DTPA. Allstate responded and moved for summary judgment, arguing that it was justified in denying coverage because Santacruz had violated the policy's requirement that he permit access to the property and because Santacruz could not establish that Allstate acted in bad faith.

In ruling on Allstate's motion for summary judgment, the district court rejected Allstate's argument that it was justified in denying coverage based on Santacruz's alleged violation of the policy requirement that he permit Allstate to access the property to investigate the claim. The district court ruled that the anti-technicality provision in § 862.054 of the Texas Insurance Code prevented Allstate from denying coverage because Santacruz's immediate repair of his roof, which denied Allstate access to the damaged property, did not contribute to the damage at issue. Because the immediate repair of the roof did not contribute to the damage at issue, the denial of access was merely a technical breach that was, by itself, an insufficient basis to deny coverage.

The district court eventually granted summary judgment in favor of Allstate on the grounds that Santacruz failed to establish Allstate acted in bad faith.

INSURANCE APPLICATION MISREPRESENTATION: INTENT TO DECEIVE REQUIRED

***Medicus Ins. Co. v. Todd*, 400 S.W.3d 670 (Tex. App.—Dallas 2013, no pet.).**

Insurer must prove intent to deceive in order to void a policy for misrepresentation on an application.

From 2006 through 2008, Medicus issued medical malpractice coverage to Dr. Frederick Todd. Medicus's business plan was to keep its costs low by offering insurance at low premiums only to physicians with few claims, generally fewer than five claims. Medicus agreed to insure Dr. Todd based, in part, on the applications reviewed by Larry Zimmer, Dr. Todd's malpractice insurance broker, and submitted by Dr. Todd.

In the applications, Dr. Todd represented that he had never been the subject of an investigation by any licensing authority and omitted information regarding certain lawsuits and threatened lawsuits against him, while admitting the existence of four lawsuits. Dr. Todd signed each application declaring the information was true and correct.

But the Texas Medical Board had, in fact, conducted two investigations of Dr. Todd arising from three or more medical malpractice claims in a five-year period. In the same applications, neither Dr. Todd nor Zimmer added information regarding eight lawsuits that had been filed against Dr. Todd or three letters from lawyers threatening suit.

After renewing Dr. Todd's insurance in 2008, Medicus discovered the undisclosed lawsuits and Texas Medical Board investigations. Medicus returned the premium to Dr. Todd and cancelled the policy.

Medicus brought suit seeking a declaration that the policy was void and it did not have a duty defend or indemnify. Dr. Todd counterclaimed for breach of contract. The case was tried before a jury. The jury

determined that Medicus failed to prove Dr. Todd intended to deceive Medicus. The trial court rendered a take nothing judgment against Medicus and awarded Dr. Todd's attorney's fees. Medicus appealed.

On appeal, Medicus argued that an insurer seeking to declare a policy void due to misrepresentations in the application has two remedies; an insurer may rely on the common-law remedy, in which the insurer must prove an insured intended to deceive the insurer, or may rely on the statutory remedy under Section 705.004 of the Texas Insurance Code, which does not expressly require the insurer to prove the insured had the intent to deceive. Medicus contended in its second and third issues that it brought suit under the statute, not the common-law, and therefore it was not required to prove Dr. Todd's intent to deceive. While the court of appeals noted that the statute does not expressly require the misrepresentation be made with the intent deceive, the court rejected Medicus's argument relying on a string of Texas Supreme Court cases dating back to 1933 that impose the requirement on an insurer to prove the insurance applicant's intent to deceive despite the language of the statute.

The court of appeals affirmed the trial court's judgment, holding that an insurer seeking to declare a policy void due to misrepresentations in an application for insurance must prove the applicant's intent to deceive under both the common-law and statutory remedies.

STOWERS DOCTRINE: FULLY ADVERSARIAL TRIAL REQUIREMENT

***Yorkshire Ins. Co. v. Seger*, 407 S.W.3d 435 (Tex. App.—Amarillo 2013, pet. filed).**

Because underlying liability judgment was not the result of a fully adversarial trial, plaintiff in the underlying suit who was assigned underlying defendant/insured's Stowers action did not establish damages as a matter of law.

Randall Seger died when the oil rig he was working on collapsed. Subsequently, Seger's family (the "plaintiffs") sued several allegedly responsible defendants. One of those of defendants, Diatom, had a CGL policy issued by Yorkshire. Seger's family made a Stowers demand on Diatom, and Diatom made demand on Yorkshire to settle the claim for policy limits. Yorkshire refused to pay on plaintiffs' Stowers demand. The case went to trial, and the trial court awarded judgment for plaintiffs for $7.5 million each plus pre- and post-judgment interest, well above the policy limits.

Plaintiffs then took an assignment of the defendant's claims against Yorkshire and brought a bad-faith, Stowers action against Yorkshire. The court in the Stowers action resolved several issues by summary judgment, including a finding that the parties in the underlying proceeding were in a "fully adversarial relationship" and that the proceeding was a "trial," so the only issues that remained for determination at the Stowers trial were negligence, causation, and damages. During the Stowers trial, the trial court directed the verdict as to damages based on the underlying judgment. The questions of negligence and causation were submitted to a jury, and the jury returned a verdict in favor of plaintiffs.

Yorkshire appealed the trial court's judgment, and the court of appeals reversed the judgment and remanded the case for a new trial. After the case was remanded, it was called for trial and submitted to a jury. Based on the jury's findings, the trial court entered a judgment awarding $35 million to each plaintiff. Yorkshire appealed challenging the validity of the underlying liability judgment.

The court of appeals' opinion turned on the applicability of *State Farm Fire & Casualty Co. v. Gandy*, a Texas Supreme Court opinion that carved out an exception to the Stowers doctrine when an insured assigns her Stowers action to a plaintiff in the underlying suit prior to judgment. The Texas Supreme Court in *Gandy* held that "[w]hen such [pre-judgment assignment] occurs, the underlying judgment is not conclusive [evidence of damages], but is inadmissible as evidence of damages, unless rendered as the result of a 'fully adversarial trial.'"

On appeal, Yorkshire contended the underlying liability judgment was not the result of a fully adversarial trial and therefore did not establish damages as a matter of law. Yorkshire highlighted the questionable proceedings and unusual circumstances in the underlying trial, *to wit*: Diatom's attorney withdrew from the case before trial; Diatom did not announce ready when the trial was called; Diatom did not present opening or closing arguments; Diatom did not offer any evidence and did not cross-examine any of plaintiffs' witnesses. While plaintiffs subpoenaed Diatom's general partner, the witness did not appear as a corporate representative for Diatom.

On appeal, plaintiffs argued that *Gandy* did not apply because the underlying case was actually tried before the assignment was granted and because a recent Texas Supreme Court case, *Evanston Ins. Co. v. ATOFINA Petrochemicals, Inc.*, eliminated the requirement of a fully adversarial trial. Turning to plaintiffs' attempt to avoid *Gandy* by postponing the insured's assignment until after the underlying trial on the merits, the court of appeals rejected this argument and held that *Gandy* bars any judgment, regardless of when the assignment occurs, unless the judgment was the result of a fully adversarial trial on the merits. The court of appeals next turned to plaintiffs' contention that *ATOFINA* overturned *Gandy's* requirement of a fully adversarial trial on the merits. Rejecting this argument by plaintiffs, the court of appeals distinguished *ATOFINA* because that case involved neither a Stowers demand nor an assignment of the claim against the insurer rendering *ATOFINA* irrelevant to the court's analysis. The court of appeals therefore concluded that *ATOFINA* did not control.

Ultimately, the court of appeals concluded that the judgment against Yorkshire was not the result of a fully adversarial trial, reversed the trial court's judgment in favor of plaintiffs, and rendered a take-nothing judgment against plaintiffs.

DEFENSE COSTS

***Steadfast Ins. Co. v. Archer D. Bonnema*, No. 11-CV-00146-ALM (E.D. Tex. Jul. 26, 2013).**

Insurer's agreement for payment of attorney's fees for the defense of claims against the insured did not cover fees expended to pursue litigation, including affirmative claims on behalf of the insured that were unrelated to the defense of claims.

IMPAIRED PROPERTY EXCLUSION

***U.S. Metals, Inc. v. Liberty Mut. Group, Inc.*, Civil Action No. H-12-379 (S.D. Tex. July 2, 2013).**

Where there is no allegation that the product's defect caused independent damage, impaired property exclusion precluded coverage for damage to property other than the insured's product that occurred during the repair and replacement process.

U.S. Metals, the insured under a CGL and umbrella policy, was sued and eventually settled a lawsuit with Exxon concerning damage to Exxon equipment and loss of use of two Exxon refineries caused by defective flanges supplied by U.S. Metals. Prior to settlement, U.S. Metals submitted the defense and indemnification of the Exxon lawsuit to Liberty Mutual. Liberty Mutual denied coverage and refused to defend or indemnify U.S. Metals based on its opinion that, among other things, the "Damage to Your Product" and the "Damage to Impaired Property or Property Not Physically Injured" exclusions precluded coverage. Both parties filed for summary judgment.

The significant issue before the district court was whether, as to the duty to indemnify, an "impaired property" exclusion precludes coverage for damage to property other than the insured's product that occurs during the repair and replacement process, where there are no facts or allegations that the product's defect caused independent damage.

The "impaired property" exclusion excluded coverage for claims arising out of "'property damage' to 'impaired property' or property that has not been physically injured, arising out of: (1) defect, deficiency, inadequacy, or dangerous condition in 'your product' or 'your' work." The policy defined "impaired property" as "tangible property . . . 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 the repair, replacement, adjustment or removal of 'your product' or 'your work' or your fulfilling the terms of the contract or agreement."

Liberty Mutual claimed that the "impaired property" exclusion applied to preclude coverage for "any aspect of Exxon's claim for property damage involving the removal and replacement of the flanges or for loss of use of the refineries while the flanges were replaced." In support of its position, Liberty Mutual relied upon *Gentry Machine Works, Inc. v. Harleysville Mutual Insurance Co.*, 621 F. Supp. 2d 1288, 1298 (M.D. Ga. 2008). In *Gentry*, the district court followed the majority position concerning business risk exclusions and held that damage during the repair and replacement process to equipment or components other than the insured's was precluded from coverage by the "impaired property" exclusion because such damages were the direct result of the repair and replacement process, rather than the failure of the insured's product.

U.S. Metals countered that the exclusion did not apply because Exxon's refineries could not be

restored to use by repair and replacement of the defective flanges alone—Exxon had to remove and replace other parts of the unit that were damaged during repair and replacement of the flanges. Essentially, U.S. Metals argued that, although the cost of the flanges themselves was not covered, the damages related to the cost of repair and replacement of other Exxon equipment damaged during the replacement of the flanges, and the damages caused by loss of use of the two Exxon refineries was not precluded by the "impaired property" exclusion because those damages were the ultimate result of the failure of the flanges supplied by U.S. metals.

The district court ultimately rejected U.S. Metals' argument, relying, in part, on analogous principles in *Building Specialties, Inc. v. Liberty Mutual Fire Insurance Co.*, 712 F. Supp. 2d 628 (S.D. Tex. 2010), where the court found that repair and replacement work that damages other property should be considered part of the cost of the repair itself. The court reasoned that the damages at issue did not result from failure of the flanges but from the investigation, repair, and replacement of the flanges. In reaching its opinion, the court also expressly declined to follow the contrary interpretation of the "impaired property" exclusion found in *Employers Mutual Casualty Co. v. Grayson*, CIV-07-917-C, 2008 WL 2278593 (W.D. Okla. May 30, 2008).