

Case No. 05-0832

IN THE SUPREME COURT OF TEXAS

LAMAR HOMES, INC.,

Appellant,

v.

MID-CONTINENT CASUALTY COMPANY,

Appellee,

Brief of *Amicus Curiae*

Complex Insurance Claims Litigation Association

In Support of Mid-Continent Casualty Company

On Certification from the United States Court of Appeals for the Fifth Circuit,
No. 04-51074

Laura A. Foggan
John C. Yang
WILEY REIN & FIELDING LLP
1776 K Street, NW
Washington, DC 20006
(202) 719-7000 (phone)
(202) 719-7049 (fax)

Of Counsel

Wade Crosnoe
State Bar No. 00783903
THOMPSON, COE, COUSINS &
IRONS, L.L.P.
701 Brazos
1500 Austin Centre
Austin, Texas 78701
(512) 703-5078 (phone)
(512) 708-8777 (fax)

*Counsel for Amicus Curiae
Complex Insurance Claims
Litigation Association*

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INTEREST OF AMICUS CURIAE

The Complex Insurance Claims Litigation Association (“CICLA”) is a trade association of major property and casualty insurance companies. CICLA submits this brief on behalf of the following member companies: AIG Insurance Companies; Chubb and Son – a Division of Federal Insurance Company; Farmers Insurance Group; Liberty Mutual Insurance Company; Selective Insurance Company of America; St. Paul Fire and Marine Insurance Company; The Travelers Indemnity Company; and Zurich American Insurance Company. CICLA members have written a substantial amount of insurance in Texas and frequently issue policies in Texas and elsewhere with provisions similar to those at issue here. Through *amicus curiae* participation, CICLA seeks to assist courts in deciding important insurance coverage cases. The fees and costs for this brief have been paid entirely by CICLA.

This case addresses, as a matter of first impression in this Court, the definition and application of the terms “occurrence” and “property damage.” CICLA’s members are interested in these issues because they have issued many policies containing similar or exact language in Texas. It is vitally important that this language be interpreted in a straightforward manner and in accordance with general principles of contract interpretation. Additionally, this case presents, as a matter of first impression in this Court, the question of the applicability of article 21.55 to the duty to defend provisions contained in third-party liability policies. CICLA members have an interest in the interpretation of this statute because of the large number of policies they have issued in

Texas. Furthermore, CICLA members are vitally interested in ensuring that the clear distinctions between first-party policies and third-party policies are maintained.

CICLA has participated in numerous cases presenting important insurance questions throughout the country, including several before this Court. *See, e.g., Excess Underwriters at Lloyd's London v. Frank's Casing Crew & Rental Tools, Inc.*, 48 Tex. Sup. Ct. J. 735 (May 27, 2005) (reh'g granted); *Tex. Ass'n of Counties County Gov't Risk Mgmt. Pool v. Matagorda County*, 52 S.W.3d 128 (Tex. 2000); *Grapevine Excavation, Inc. v. Md. Lloyds*, 35 S.W.3d 1 (Tex. 2000); *Nat'l Union Fire Ins. Co. v. CBI Indus., Inc.*, 907 S.W.2d 517 (Tex. 1995); *Kelley-Coppedge, Inc. v. Highlands Ins. Co.*, 980 S.W.2d. 462 (Tex. 1998); *see also Gulf Metals Indus., Inc. v. Chicago Ins. Co.*, 993 S.W.2d 800 (Tex. App.—Austin 1999, pet. denied); *Tri County Serv. Co. v. Nationwide Mut. Ins. Co.*, 873 S.W.2d 719 (Tex. App.—San Antonio 1993, writ denied). CICLA respectfully submits that its participation would assist the Court in this case.

ISSUES PRESENTED

The United States Court of Appeals for the Fifth Circuit certified three questions to this Court:

1. When a homebuyer sues his general contractor for construction defects and alleges only damage or loss of use of the home itself, do such allegations allege an “accident” or “occurrence” sufficient to trigger the duty to defend or indemnify under a CGL policy?
2. When a homebuyer sues his general contractor for construction defects and alleges only damage to or loss of use of the home itself, do such allegations allege

“property damage” sufficient to trigger the duty to defend or indemnify under a CGL policy?

3. If the answers to certified questions 1 and 2 are answered in the affirmative, does Article 21.55 of the Texas Insurance Code apply to a CGL insurer’s breach of the duty to defend?

STATEMENT OF FACTS

CICLA incorporates by reference the statement of facts in Appellee Mid-Continent Casualty Company’s brief before this Court. CICLA only highlights those facts that are important to its arguments.

The underlying claim against Lamar Homes is a claim alleging that Lamar Homes “failed to design and/or construct the foundation of the residence in a good and workmanlike fashion.” This deficient work has resulted in foundation deflection, cracks in the sheetrock and stone veneer, and binding/ghosting doors. As set forth in the complaint, the damages sought are “costs to repair defects in the home, the loss in fair market value measured by the difference of the value of the home as represented by Defendants and the value of the home as received by the Plaintiffs, stigma loss in fair market value in the home after repairs, costs to restore landscaping after repairs, professional engineering and appraisal fees resulting from the inspection and evaluation of the condition of the plaintiffs’ home, temporary lodging and dining expenses, the development of a plan of remediation, moving and storage of Plaintiffs’ personal property, costs of depositions, and mental anguish.”

The policy defines “occurrence” as “an accident, including continuous or repeated exposure to substantially the same general harmful conditions.” The policy defines “property damage” as “[p]hysical injury to tangible property, including all resulting loss of use of that property ... or [l]oss of use of tangible property that is not physically injured.”

SUMMARY OF THE ARGUMENT

Lamar Homes is seeking coverage for losses stemming from its breach of a contract with a third party. By doing so, Lamar Homes seeks to transform its liability policy into a performance bond and to make the insurer a surety for the contractor’s work. This transformation should be rejected based on the plain policy language.

A claim arising out of a policyholder’s failure to perform its contract cannot constitute an occurrence. Because a breach of contract is a volitional act, finding coverage would violate the fortuity principle inherent in the definition of occurrence. A breach of contract is also not an accident. A policyholder’s failure to fulfill its contractual obligation is a risk that is retained by the policyholder. Any other conclusion would eliminate the policyholder’s duty to live up to its contract obligations, allowing the policyholder to rely on its insurer to remedy any deficiencies.

In addition, construction defects affecting only the policyholder’s construction are not property damage. Liability policies provide coverage for third-party damage, not defects in the policyholder’s own work. Stated differently, such defects do not constitute “property damage” because the work was never undamaged.

Finally, article 21.55 does not extend to a breach of the duty to defend because, by its terms, the statute relates only to the first-party claims of a policyholder. Article 21.55 cannot apply here because the duty to defend and claims for defense costs are third-party claims. Due to the requirements of the statute, application would defy common sense. Additionally, extending article 21.55 to the duty to defend would improperly blur the line between third-party and first-party insurance.

ARGUMENT

I. A BREACH OF CONTRACT IS NOT AN OCCURRENCE BECAUSE IT IS A VOLITIONAL ACT AND NOT AN ACCIDENT.

General principles of insurance law dictate that a general liability policy is designed to respond to accidents and not to volitional acts like a breach of contract. Claims arising from a breach of contract caused by defective manufacture, when there has been no damage to any property other than the policyholder's own construction, cannot constitute an "occurrence." Extending coverage to breach of contract claims, including breach of implied warranties, would change the nature of the insurance policy by making the insurer a surety for the policyholder's work. This would turn the policy into a performance bond. Such risks of nonperformance are not included in the policies and insurers have not been paid premiums by policyholders for them. For all of these reasons, contractual losses should not be imposed on insurers.

A. General Liability Policies Do Not Cover Costs of Doing Business Which Include the Foreseeable Costs of a Breach of Contract.

1. Breach of contract claims are not covered under general liability policies.

An occurrence is defined as an accident; an accident must be unforeseen.

Specifically, an accident is a fortuitous and unexpected event. *Trinity Universal Ins. Co. v. Cowan*, 945 S.W.2d 819, 828 (Tex. 1997) (describing an accident as a “fortuitous, unexpected, or undesigned injury”) (quoting *State Farm Fire & Cas. Co. v. S.S.*, 858 S.W.2d 374, 377 (Tex. 1993)). A breach of contract, in contrast to an occurrence, is not an accident, but the logical conclusion of a party failing to fulfill its voluntarily assumed contractual obligations. Part of assuming a contractual obligation is understanding the consequences of a breach, and considering those consequences when contracting. Accordingly, breach of contract claims are not covered under general liability insurance policies.

This conclusion is consistent with Texas law. The United States Court of Appeals for the Fifth Circuit, applying Texas law, has stated that losses from a breach of contract are foreseeable and in the contemplation of the parties, and therefore not covered. *Hartford Cas. Co. v. Cruse*, 938 F.2d 601 (5th Cir. 1991). In that case, the insured contractor was sued for breach of warranties and negligence relating to its defective foundation leveling resulting in damage to the house. Ruling that these defects are a breach of contract and so not covered, the court stated that damages arising “from a breach of contract are conclusively presumed to have been in the contemplation of the parties and may therefore constitute expected or intended damages.” *Id.* at 604. The

doctrinal basis for this statement is that, whereas an accident cannot be controlled, the policyholder can and should control its contractual relationships. *See id.* at 603, 604-05.¹

Well-reasoned Texas opinions hold that construction defect claims sound in contract. Those claims are foreseeable and are not occurrences. For example, the First Court of Appeals has specifically applied this concept of foreseeability to contractual liability based upon a breach of implied warranty. *Hartrick v. Great Am. Lloyds Ins., Co.*, 62 S.W.3d 270 (Tex. App.—Houston [1st Dist.] 2001, no pet.). In that case, the insured contractor breached its implied warranties by constructing a house with defects in the poured slab foundation. The court noted that, for an effect of an act to be accidental the “effect could not reasonably have been anticipated from the conduct that produced it, and the insured ‘cannot be charged with the design of producing’ the effect.” *Id.* at 277 (citations omitted). The court recognized that, because the damages were the result of the breach of implied warranties, the damages were “reasonably foreseeable results.” *Id.* The court found that a breach of warranty is not accidental, but “the result of [the policyholder] not doing what it was required to do.” *Id.* at 278.

This Court has ruled that, although there is an intermingling of tort and contract elements in a breach of implied warranty case, the claim is contractual and not a tort. *Jim Walter Homes, Inc. v. Reed*, 711 S.W.2d 617 (Tex. 1986). In *Jim Walter Homes*, plaintiffs were seeking damages arising from the sale and construction of their house and obtained a jury verdict that defendant had breached the warranty of good workmanship.

¹ The court ultimately found coverage only because the policyholder’s work had damaged other parts of the home not the subject of the policyholder’s contract with the claimant. *Id.* at 605.

As this Court stated, plaintiff did not receive “the house they were promised and paid for.” *Id.* at 618. This Court held that this sort of claim is one for economic loss and “sounds in contract alone.” *Id.* Because such claims sound in contract, they are not covered by liability policies, which provide coverage for tort liability to others, not contract claims.

Courts around the country agree that general liability policies are intended to insure against third-party tort damages and not contract damages. For example, in *Action Ads, Inc. v. Great American Insurance Co.*, 685 P.2d 42 (Wyo. 1984), the Wyoming Supreme Court held that the general liability coverage provisions refer “to liability sounding in tort, not in contract.” *Id.* at 43-44. In that case, the employer was contractually obligated to obtain medical insurance for the plaintiff but failed to do so. In failing to do so, the court held that this was not a risk within the policy because this was a risk the employer chose “to assume pursuant to contract.” *Id.* at 45. Therefore, the contractual risk of failing to construct a home in a workmanlike manner would also be a risk the policyholder chose to assume by contract and not a risk that general liability policies are intended to cover.

Additionally, many of these cases have arisen specifically in the construction context. For example, in *Redevelopment Authority of Cambria County v. International Insurance Co.*, 685 A.2d 581 (Pa. Super. Ct. 1996), the policyholder was contractually obligated to run the water system for the township and failed to do so properly. In its analysis, the Pennsylvania intermediate appellate court stated that, in order to determine the proper characterization of the action, “the important difference between contract and

tort actions is that the latter lie from the breach of duties imposed as a matter of social policy while the former lie for the breach of duties imposed by mutual consensus.” *Id.* at 590. Ruling that there is no coverage for damages arising out of the contractual obligations, the court noted that, while there were allegations of negligence, the obligation to act was a result of the contractual relationship such that the actions were properly characterized as sounding in contract. *Id.* The court concluded that there could be no expectation of coverage for such contract actions. *Id.* at 592 (“The express provisions of the insurance contract do not provide coverage for the claims in the underlying action which arise out of and relate to the contract between the parties, and the Authority ... could not have reasonably expected that the Erie policy was to act as a performance bond insuring the performance of the contractual duties which the Authority undertook pursuant to the 1987 contract.”).

A New York intermediate appellate court similarly has decided that claims based on contractual liability are not covered under a general liability policy. *Hartford Accident & Indem. Co. v. A.P. Reale & Sons Inc.*, 644 N.Y.S.2d 442 (N.Y. App. Div. 1996). In that case, the policyholder contracted to build a sewage treatment facility and was sued for its failure to do so in accordance with the plans and specifications. Ruling that there was no coverage within the scope of general liability policies for such claims, the court described the purpose of general liability policies: “We note that this disposition is in accord with the purpose of a commercial general liability policy which is to provide coverage for tort liability for physical damage to others and not for contractual liability of the insured for economic loss because the product or completed work is not what the

damaged person bargained for.” *Id.* at 443 (citing Henderson, *Insurance Protection for Products Liability and Completed Operations – What Every Lawyer Should Know*, 50 Neb. L. Rev. 415, 441 (1971)).²

The decisions of these courts are rooted in a clear understanding of the insurance mechanism and sound public policy. Providing coverage for breach of contract claims could create an incentive for policyholders to do poor work and then seek reimbursement from their insurer to fulfill the terms of their contract. This extension of coverage would erode the need for the policyholder to fulfill their obligations – at least until insurance premiums accounted for this risk. With increased risk to insurers, insurance would become more expensive and less easily available, creating difficulties for most contractors, including those who do honor their agreements.

These cases and the sound public policy supporting them require that there be no coverage in the case before this Court. Lamar Homes is accused of nothing other than failing to build the quality of house it was contractually obligated to build. The claims

² A prominent commentator agrees: “As policies of liability insurance are designed to cover an insured’s tort liability liability based upon contract is generally excluded from coverage.” 7A Lee R. Russ & Thomas F. Segalla, *Couch on Insurance* § 103:19 (3d ed. 1997 & Supp. 2005) (citing *Chamberlain v. Allstate Ins. Co.*, 931 F.2d 1361 (9th Cir. 1991) (applying California law); *SLA Prop. Mgmt. v. Angelina Cas. Co.*, 856 F.2d 69 (8th Cir. 1988) (applying South Dakota law); *Cheek v. Williams-McWilliams Co.*, 697 F.2d 649 (5th Cir. 1983) (applying Louisiana law); *Ins. Co. of the W. v. Haralambos Beverage Co.*, 241 Cal. Rptr. 427 (2d Dist. 1987); *Yegge v. Integrity Mut. Ins. Co.*, 534 N.W.2d 100 (Iowa 1995); *Aetna Cas. & Surety Co. v. Cotter*, 522 N.E.2d 1013 (Mass. 1988); *Kisle v. St. Paul Fire & Marine Ins. Co.*, 495 P.2d 1198 (Or. 1972); *Harrison Plumbing & Heating, Inc. v. New Hampshire Ins. Group*, 681 P.2d 875 (Wash. Ct. App. 1984)).

It is observed that some contractual coverage is available, but only where it is specifically bought in addition to the standard grant of coverage. 7A Lee R. Russ & Thomas F. Segalla, *Couch on Insurance* § 103:19 (3d ed. 1997 & Supp. 2005); *see also* 7A Appleman, *Insurance Law and Practice* § 4493, p.55-56 (1979 & Supp. 2005) (“Exposure to contractual liability requires separate coverage.”).

arise directly from Lamar Homes' contractual obligation to manufacture a home meeting minimum standards of quality. The defects that result from this failure to comply with a contract are not insured under general liability insurance contracts.

2. A defect in the policyholder's own work is not an occurrence.

The mere existence of a policyholder's defective work is not an "occurrence." An occurrence is an accident; it is not the need to correct the policyholder's work because of its initially defective state. It is a well-settled principle that "the purpose of comprehensive liability insurance coverage for a builder is to protect the insured from liability resulting from property damage (or bodily injury) caused by the insured's product, but not for the replacement or repair of that product." *Jim Johnson Homes, Inc. v. Mid-Continent Cas. Co.*, 244 F. Supp. 2d 706, 714 (N.D. Tex. 2003) (citing *T.C. Bateson Constr. Co. v. Lumbermens Mut. Cas. Co.*, 784 S.W.2d 692, 694-95 (Tex. App.—Houston [14th Dist] 1989, writ denied)); see also *Hartrick v. Great Am. Lloyds Ins. Co.*, 62 S.W.3d 270, 277-78 (Tex. App.—Houston [1st Dist] 2001, no pet.). Replacement or correction of the policyholder's own work does not constitute an "accident" within the meaning of the "occurrence" definition. For this reason as well, no coverage exists for defective work.

Courts around the country agree with the long line of Texas law concluding that damage to a policyholder's own work is not an occurrence. For instance, the intermediate appellate court of Maryland recognized in a similar case that a breach of contract in the construction defect context cannot constitute an occurrence. *Lerner Corp. v. Assurance Co. of Am.*, 707 A.2d 906 (Md. Ct. Spec. App. 1998). Approximately nine

years following construction on a building, the owner notified the contractor that façade panels were deteriorating due to deficient construction. The insured contractor fixed the façade and then sought indemnification from its general liability insurer for the cost. *Id.* at 908. The court ruled that the need to repair deficient work is not unforeseeable and therefore not an occurrence: “If the damages suffered relate to the satisfaction of the contractual bargain, it follows that they are not unforeseen. In other words ... it should not be unexpected and unforeseen that, if the Building delivered does not meet the contract requirements of the sale, the purchaser will be entitled to correction of the defect.” *Id.* at 912.

The Missouri Court of Appeals has likewise held that a breach of contract in the construction defect context is not an accident or occurrence. *Am. States Ins. Co. v. Mathis*, 974 S.W.2d 647 (Mo. Ct. App. 1998). The policyholder was sued for “negligence, negligent misrepresentation, and breach of contract” relating to the failure of a sub-subcontractor to properly install an integrated electrical, security, and communications system. *Id.* at 648. The damages related only to the costs of removing the faulty work and replacing it. *Id.* The court found that this was not an accident or occurrence: “Such a breach of a defined contractual duty cannot fall within the term ‘accident.’ Performance of its contract according to the terms specified therein was within [sub-subcontractor’s] control and management and its failure to perform cannot be described as an undesigned or unexpected event.” *Id.* at 650; *see also ACS Constr. Co., Inc. v. CGU*, 332 F.3d 885, 891 (5th Cir. 2003) (“The faulty workmanship of [subcontractors] unfortunately amounts to negligence. Hiring subcontractors and

installing the waterproofing membranes were not accidents under the terms of the policy.”); *Norwalk Ready Mixed Concrete, Inc. v. Travelers Ins. Cos.*, 246 F.3d 1132, 1137 (8th Cir. 2001) (quoting *Central Bearings Co. v. Wolverine Ins. Co.*, 179 N.W.2d 443, 448 (Iowa 1970)) (“a claim characterized essentially as one for a contractor’s defective workmanship in construction of a foundation, ‘resulting in damages only to the work product itself,’ was not caused by an ‘occurrence’ under Iowa law”)); *Lenning v. Commercial Union Ins. Co.*, 260 F.3d 574, 583 (6th Cir. 2001) (applying Kentucky law) (“The majority of courts to consider the issue have concluded that policies do not provide coverage where the damages claimed are the cost of correcting the work itself, even in the context of the broad protections offered by comprehensive general liability (“CGL”) policies.”); *Hartford Accid. & Indem. Co. v. A.P. Reale & Sons, Inc.*, 644 N.Y.S.2d 442, 443 (N.Y. App. Div. 1998); *Royal Plastics, Inc. v. State Auto. Mut. Ins. Co.*, 650 N.E.2d 180, 183 (Ohio Ct. App. 1994) (ruling that the damage claimed was damage to the subject of the contract based on improper manufacture and this could not be construed to be an accident which would constitute an occurrence).

Contrary to the suggestion of Lamar Homes, *Federated Mutual Insurance Co. v. Grapevine Excavation Inc.*, 197 F.3d 720 (5th Cir. 2000), does not reach a different conclusion. In *Grapevine Excavation*, the Fifth Circuit held that there was an occurrence resulting in property damage when the insured’s negligent filling of soil resulted in damage to the asphalt cover of a parking lot, which was property not the subject of the policyholder’s contract. *Id.* at 726. As noted by the *Lamar Homes* district court: “*Grapevine Excavation* does no more than recognize that an occurrence or accident may

be present when an insured is negligent and *is* present when that negligence harms a third party but *is not* present when the insured commits an intentional tort.” *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 335 F. Supp. 2d 754, 760 (W.D. Tex. 2004).³ *Grapevine Excavation* does not stand for the broad proposition that negligence alone constitutes an occurrence, but that negligent conduct resulting in damage to a third-party is generally an occurrence. *Id.* at 725.

As these cases so clearly express, there can be no coverage for the defective construction by Lamar Homes alone. Lamar Homes is seeking coverage for a claim that the house it constructed is defective, not that it has injured someone or property not the subject of the contract. Therefore, the claimed damages for replacement and correction are not occurrences and are not covered.

3. Policyholders cannot use exclusions to expand coverage.

An exclusion, by its very nature, excludes coverage and does not grant coverage. Lamar Homes should not be allowed to create coverage through interpretation of an exclusion – particularly when it has not shown that there is coverage in the first instance. *State Farm Fire & Cas. Co. v. Volding*, 426 S.W.2d 907, 909 (Tex. App.—Dallas 1968, writ ref’d n.r.e.) (“an exclusionary clause ... can never be said to create coverage where none existed before”). Here, there is no risk of a definition of “occurrence” rendering an exclusion meaningless, so this Court’s warning in *King v. Dallas Fire Insurance Co.*, 85

³ Courts concluding otherwise have relied on an understanding of *Grapevine Excavation* identifying an occurrence whenever negligent conduct has been alleged. See, e.g., *Gehan Homes, Ltd. v. Employers Mut. Cas. Co.*, 146 S.W.3d 833, 840 (Tex. App. – Dallas 2004, pet. filed); *CU Lloyd’s of Tex. v. Main Street Homes, Inc.*, 79 S.W.3d 687, 693-94 (Tex. App. – Austin 2002, no pet.); *Great Am. Ins. Co. v. Calli Homes, Inc.*, 236 F. Supp. 2d 693, 699-700 (S.D. Tex. 2002).

S.W.3d 185, 192-93 (Tex. 2002), has no application here. Defining “occurrence” to preclude coverage for breach of warranty and defective construction cases does not render the “your work” exclusion meaningless. This exclusion bars coverage where negligence and accidents result in no harm to others, but coverage is available where there is damage to other people or other property. This coverage can be significant. *See Stumph v. Dallas Fire Ins. Co.*, 34 S.W.3d 722 (Tex. App.—Austin 2000) (finding coverage for concrete and paint dropped on vehicles near construction site).

Courts around the country have similarly held that an exclusion should not be used to create coverage when the policyholder has not shown that there was coverage under the initial grant of coverage in their policy. The Supreme Court of Florida, in a construction defect case, stated that a policyholder cannot rely on an exclusion to create coverage where none exists. Simply put, exclusions exclude coverage and do not create coverage. *LaMarche v. Shelby Mut. Ins. Co.*, 390 So.2d 325, 326 (Fla. 1980) (“The district court was correct in concluding that an exclusion does not provide coverage but limits coverage.”). More recently, in a case where a policyholder was attempting to use exclusion *l*, like Lamar Homes in this case, the District Court of Appeal of Florida reiterated that this exclusion “cannot create coverage where there is no coverage in the first place. The insured has failed to demonstrate that there are any provisions in the coverage section of the policy which would provide coverage for this defective work.” *Lassiter Constr. Co. v. Am. States Ins. Co.*, 699 So.2d 768, 770 (Fla. Dist. Ct. App. 1997).

The Indiana appellate courts similarly have addressed the subcontractor exception to exclusion *l* and held that there was no occurrence and, therefore, no coverage. *R.N. Thompson & Assocs., Inc. v. Monroe Guar. Ins. Co.*, 686 N.E.2d 160 (Ind. Ct. App. 1997). In that case, the damages were the cost to replace and correct defectively designed condominium units. *Id.* at 161. The Indiana appellate court cited an Indiana Supreme Court decision for the proposition that the business expense of complying with contractual obligations does not constitute property damage. *Id.* at 162 (citing *Indiana Ins. Co. v. DeZutti*, 408 N.E.2d 1275, 1279 (Ind. 1980)). The court, therefore, ruled that there was no coverage despite the existence of exclusion *l*.

Likewise, the Maryland intermediate appellate court rejected an attempt to create coverage through the use of an exclusion, and cited Texas law for support. *Am. Home Assurance Co. v. Osbourn*, 422 A.2d 8, 14 (Md. Ct. Spec. App. 1980) (citing, among others, *State Farm Fire & Casualty Co. v. Volding*, 426 S.W.2d 907, 909 (Tex. App.—Dallas 1968, writ ref'd n.r.e.)). In reaching its conclusion, the court stated that, if there is no coverage within the sections of the policy granting coverage, then the coverage cannot be granted by an exclusion. *Id.* (citing 13 Appleman, *Insurance Law and Practice* § 7387, p.179 (1976)). The court considered it improper to consider the exclusion in determining whether the policy granted coverage in the first place. *Id.*; see also *ACS Constr. Co., Inc. of Miss. v. CGU*, 332 F.3d 885, 892 (5th Cir. 2003) (“The exclusionary language in the contract cannot be used to create coverage where none exists.”).

Conversely, several courts in addition to the *Lassiter* and *R.N. Thompson & Assocs., Inc.* have expressly stated that their holding concerning the lack of an

“occurrence” was not affected by the existence or non-existence of specific exclusions. *See, e.g., Norwalk Ready Mixed Concrete, Inc. v. Travelers Ins. Co.*, 246 F.3d 1132, 1137-38 (8th Cir. 2001) (applying Iowa law) (ruling that defective construction did not constitute an occurrence, the court states, “We find it unnecessary, as a result, to further address Norwalk’s argument that the general liability policy’s business risk exclusion is not implicated nor its alternative argument that even if the exclusion did apply it frustrated its reasonable expectation of coverage in such a manner to render the exclusion invalid under Iowa law.”); *Erie Ins. Prop. and Cas. Co. v. Pioneer Home Improvement, Inc.*, 526 S.E.2d 28, 33 (W.Va. 1999) (refusing to apply the “completed operations hazard” when the policyholder had failed to show that there was an occurrence based on its faulty workmanship). Because the construction defect did not meet the insuring agreement’s definition of “occurrence,” it was unnecessary to address the potential applicability of any exclusion or exception to an exclusion.

Recognizing the strength of this case law, Lamar Homes seeks to avoid it, emphasizing that this suit is based on a revised coverage form. However, its argument provides no basis for this Court to ignore the decisions of all cases prior to this form because the definitions of occurrence and property damage did not change in relevant part. In the current form, and the policy before this Court, “occurrence” is still defined as an “accident,” and an insurer is still required only to indemnify for property damage that the policyholder becomes legally obligated to pay. A change in the exclusions is irrelevant because the insurance policy does not afford coverage in the first instance.

B. To Allow a Contractor to Recover for Construction Defects Would Change the Nature of an Occurrence Under the General Liability Policy and Allow the Policyholder to Treat the Policy as a Performance Bond.

As explained above, the law does not support creation of construction defect coverage. Practical considerations support that conclusion as well. Permitting coverage of contractual obligations under liability policies could allow policyholders to become indifferent about their own breach of their contractual obligations to a third party. Texas courts and courts applying Texas law have recognized the dangers of expanding coverage to include breach of contract and situations where the only “damage” was the policyholder’s own defective work.

A United States District Court applying Texas law noted that this would “‘enable a contractor to receive initial payment for the work from the homeowner, then receive subsequent payment from his insurance company to repair and correct deficiencies in his own work.’ This simply is not the intended function of liability insurance.” *Jim Johnson Homes, Inc. v. Mid-Continent Cas. Co.*, 244 F. Supp. 2d 706, 715 (N.D. Tex. 2003) (quoting *T.C. Bateson Constr. Co. v. Lumbermens Mut. Cas. Co.*, 784 S.W.2d 692, 695 (Tex. App.—Houston [14th Dist.] 1989, writ denied)). As that court also noted, the insurance agreement does not have the qualities of a performance bond because a performance bond requires the contractor to reimburse the surety, a requirement not present in an insurance policy. *Id.*

Courts in other jurisdictions similarly have recognized the inappropriateness of providing coverage in this situation. It was this fear of encouraging breaches of contract

that prompted the court in *WDC Venture* to rule that obligations stemming from contractual relations are uninsurable risks. *WDC Venture v. Hartford Accident & Indem. Co.*, 938 F. Supp. 671, 679 (D. Haw. 1996). As noted by the court in *Redevelopment Authority of Cambria County*, providing coverage would result in an enormous risk of liability for the insurer without corresponding compensation. 685 A.2d at 590. The court stated that the policyholder “could not have reasonably expected that the Erie policy was to act as a performance bond.” *Id.* at 592; *see also George A. Fuller Co. v. United States Fid. & Guar. Co.*, 613 N.Y.S.2d 152, 155 (N.Y. App. Div. 1994) (“To interpret the policy as did the IAS court would transform USF & G into a surety for the performance of Fuller’s work. USF & G’s liability policy was never intended to insure Fuller’s work product or Fuller’s compliance, as a general contractor or construction manager, with its contractual obligations.”).

The difference between insurers and sureties is significant. Unlike an insurer, a surety enters into the contractual risk with the knowledge that it has a variety of legal rights if it must pay, including a super-priority right to any remaining contract’s funds and a right to be paid back by the bond principal. Also, a surety responds only if the bond principal cannot or will not. An insurer has none of these protections.

As all of these courts recognize, policy rationales reinforce what the plain language of the contracts require: that no coverage exists for breach of contract and for defective construction, which does not constitute an “occurrence.”

II. A CONSTRUCTION DEFECT CLAIM CONCERNS ECONOMIC LOSS, NOT PROPERTY DAMAGE.

General liability policies provide coverage for property damage, but do not provide coverage for economic loss. A defective product or defective construction claim not accompanied by “damage” to property, other than the defects that are the subject of the contract, is a claim for economic loss. Texas courts have held that such claims are not covered under general liability policies, and courts around the country agree. Additionally, in order for something to be “damaged,” it must have had an undamaged state. In the case of defective manufacture, there is no undamaged state because the home was never constructed properly in the first place.

A. A Construction Defect Claim Without Third-Party Damage Constitutes Economic Loss, Not Property Damage.

Damage to the subject of a contract constitutes economic loss that is not insured under Texas law. *Hartrick v. Great Am. Lloyds Ins. Co.*, 62 S.W.3d 270, 277 (Tex. App.—Houston [1st Dist.] 2001, no pet.) (ruling that the pitching and heaving of a home’s foundation, resulting in damage to the home and loss of market value, were not covered occurrences under the policy because “these injuries were the reasonably foreseeable results that would ordinarily flow from [the contractor’s] failure to comply with its implied warranties”). In *Hartrick*, the Court of Appeals ruled that because this involved the failure of the contractor to comply with its contract, including its implied warranties, that any damage could not be considered an occurrence. *Id.* at 278. Accordingly, no coverage existed for economic losses derived from a breach of implied warranties. *Id.*

Another Texas appellate court has found that economic losses do not constitute property damage. *Great Am. Lloyd's Ins. Co. v. Mittlestadt*, 109 S.W.3d 784, 787-88 (Tex. App.—Fort Worth 2003, no pet.) (“While the Mittlestadts introduced evidence in the underlying suit supporting recovery for loss of value to the property, Texas courts have repeatedly held that economic losses do not constitute ‘property damage’ within the meaning of a general liability policy.”) (citing *State Farm Lloyds v. Kessler*, 932 S.W.2d 732, 737 (Tex. App.—Fort Worth 1996, writ denied); *Terra Int’l, Inc. v. Commonwealth Lloyd’s Ins. Co.*, 829 S.W.2d 270, 272-73 (Tex. App.—Dallas 1992, writ denied); *Houston Petroleum Co. v. Highlands Ins. Co.*, 830 S.W.2d 153, 156 (Tex. App.—Houston [1st Dist.] 1990, writ denied); *Lay v. Aetna Ins. Co.*, 599 S.W.2d 684, 686-87 (Tex. Civ. App.—Austin 1980, writ ref’d n.r.e.)). The *Mittlestadt* case involved a house built over a pipeline easement. The plaintiffs alleged negligence, reduced value of the house and, if the easement were enforced, loss of use of their home. Based on the alleged negligence, the plaintiffs sought the difference in value between that of the house with the easement and that of the house without the easement. *Id.* at 788. The court ruled that loss in value to the property is economic and does not constitute property damage. *Id.* at 787-88; *see also Gibson & Assocs., Inc. v. Home Ins. Co.*, 966 F. Supp. 468, 473-74 (N.D. Tex. 1997) (ruling with reference to a breach of contract whereby the policyholder had agreed to indemnify the City against claims made against the City, “Texas law, however, does not recognize economic damages as coming within the definition of ‘property damages’ contained in standard liability insurance policies”)

(citing *Kessler*, 932 S.W.2d at 737; *Terra Int'l Inc.*, 829 S.W.2d at 272; *Nutmeg Ins. Co. v. Pro-Line Corp.*, 836 F. Supp. 385, 388-89 (N.D. Tex. 1993)).

Texas is far from alone on this issue. For example, New York cases are also in accord. In *Hartford Accident & Indemnity Co. v. A.P. Reale & Sons Inc.*, 644 N.Y.S.2d 442 (N.Y. App. Div. 1996), the court noted that a suit where “the product or completed work is not what the damaged person bargained for” represents “economic loss” and so is not covered by a general liability policy *Id.* at 443. The ruling in that case was a reaffirmation of an earlier case that held the general liability policy “was never intended to provide contractual indemnification for economic loss to a contracting party because the work product contracted for is defectively produced.” *George A. Fuller Co. v. United States Fidel. & Guar. Co.*, 613 N.Y.S.2d 152, 155 (N.Y. App. Div. 1994), *appeal denied*, 84 N.Y.2d 806 (1994).

Lamar Homes is not entitled to coverage when the only “damage” it can identify is its own defective work. Such damages are economic in nature and cannot be recovered under a general liability policy.

B. A Defect in the Policyholder’s Construction Does Not Constitute “Property Damage.”

As an independent basis for finding that no coverage exists, this Court should conclude that there was no property damage because the house was defectively built. A defect cannot constitute property damage because the very idea of damage requires that there was an uninjured state. Otherwise, the property is merely in the state that it always has been in and cannot be considered damaged.

The Court of Appeals of North Carolina has recognized this as a prerequisite to coverage in the general liability policy context. In a case involving a claim for damages relating to the deficient construction of rubber oven feed lines, that court ruled: “The term ‘property damage’ in an insurance policy has been interpreted to mean damage to property that was *previously undamaged*, and *not* the expense of repairing property or completing a project that was not done correctly or according to contract in the first instance.” *Production Sys., Inc. v. Amerisure Ins. Co.*, 605 S.E.2d 663, 666 (N.C. Ct. App. 2004) (emphasis in original); *see also Wm. C. Vick Constr. Co. v. Pa. Nat’l Mut.*, 52 F. Supp. 2d 569, 582 (E.D.N.C. 1999), *aff’d*, 213 F.3d 634 (4th Cir. 2000).

This doctrine has been applied by Texas courts in the context of the builder’s risk policy. *N. Am. Shipbuilding, Inc. v. S. Marine & Aviation Underwriting, Inc.*, 930 S.W.2d 829 (Tex. App.—Houston [1st Dist.] 1996, no pet.). In that case, a ship was constructed with faulty welds which later had to be replaced. *Id.* at 831. The policyholder attempted to obtain coverage for this as “physical loss of or damage to the vessel.” *Id.* at 832. The court ruled that there was no coverage for the replacement of the welds because the welds were defective: “That it should cover accidents caused by the negligence of the insured does not justify reading such a policy to cover the cost of replacing or repairing crooked window frames or crooked door frames, even though the crookedness of the frame was undoubtedly the result of the insured’s negligence.” *Id.* at 833 (quoting *Trinity Indus., Inc. v. Ins. Co. of N. Am.*, 916 F.2d 267, 269-72 (5th Cir. 1990)). The court ruled that there is no coverage because there is no damage in these circumstances: “The language ‘physical loss or damage’ strongly implies that there was

an initial satisfactory state that was changed by some external event into an unsatisfactory state – for example, the car was undamaged before the collision dented the bumper. It would not ordinarily be thought to encompass faulty initial construction.” *Id.* at 833 (quoting *Trinity Indus., Inc.*, 916 F.2d at 269-72).

Lamar Homes did not damage any property; it merely failed to construct the house properly. A claim for repair or replacement because of such a defect is merely a claim that one is not satisfied with the product received, not that it has been damaged. Here, Lamar Homes cannot claim there has been property damage because it never constructed the house in a workmanlike manner in the first place.

III. ARTICLE 21.55 APPLIES ONLY TO FIRST-PARTY CLAIMS AND NOT TO THIRD PARTY CLAIMS LIKE THE DUTY TO DEFEND .

Reasoned analysis of article 21.55 of the Insurance Code by Texas courts has determined that article 21.55 does not apply to a request for defense costs because such costs do not constitute a first-party claim as required by the statute. *TIG Ins. Co. v. Dallas Basketball, Ltd.*, 129 S.W.3d 232, 239 (Tex. App.—Dallas 2004, no pet.) (expressly followed by *Service of Lloyd’s Ins. Co. v. Wink*, __S.W.3d __, No. 04-05-00038-CV, 2005 WL 2438350, at *10 (Tex. App.—San Antonio Oct. 5, 2005, pet. filed).

Article 21.55 requires the following:

Sec. 2. (a) Except as provided by Subsection (d) of this section, an insurer shall, not later than the 15th day after receipt of notice of a claim...

- (1) acknowledge receipt of the claim;
- (2) commence any investigation of the claim;
- (3) request from the claimant all items, statements, and forms that the insurer reasonably believes, at that time, will be required from the claimant. Additional requests may be made if during

the investigation of the claim such additional requests are necessary.

TEX. INS. CODE art. 21.55, § 2(a) (now recodified at TEX. INS. CODE §§ 542.051-542.061).

Additionally, the statute defines a claim as follows: “‘Claim’ means a first party claim made by an insured or a policyholder under an insurance policy or contract or by a beneficiary named in the policy or contract that must be paid by the insurer directly to the insured or beneficiary.” TEX. INS. CODE art. 21.55, § 1(3).⁴

In *Dallas Basketball*, the court held that a claim for defense costs is not a first-party claim under article 21.55 because the defense costs are meant to be paid to the to the counsel representing the policyholders. The costs represent money owed to people other than the policyholders, the court concluded. *Dallas Basketball*, 129 S.W.3d at 239; *Wink*, __ S.W.3d __, 2005 WL 2438350, at *9. This is in accord with this Court’s past rulings: a first-party claim is a claim by a policyholder for its own loss and a third-party claim is a claim for the loss of a third-party. *Universe Life Ins. Co. v. Giles*, 950 S.W.2d 48, 54 n.2 (Tex. 1997). Defense costs are only incurred when liability for third-party harm to others is at stake.

The *Dallas Basketball* court also ruled that a claim for defense costs cannot be a claim under the statute for two additional reasons. First, the statute’s time period is to begin running when the insurer receives all information necessary to prove the

⁴ Compare to TEX. INS. CODE § 542.051(2): “‘Claim’ means a first-party claim that: (A) is made by an insured or policyholder under an insurance policy or contract or by a beneficiary named in the policy or contract; and (B) must be paid by the insurer directly to the insured or beneficiary.”

policyholder's loss, something which cannot be true upon a request for defense costs. *Dallas Basketball*, 129 S.W.3d at 240; *Wink*, __ S.W.3d __, 2005 WL 2438350, at *9. Second, characterizing a request for defense costs as a first-party claim would create questions concerning when that "claim" would begin to run. Similarly, characterizing each new submission of defense costs as a new claim triggering a new statute of limitation would defy common sense. *Dallas Basketball*, 129 S.W.3d at 241; *Wink*, __ S.W.3d __, 2004 WL 2438350, at *9. That it would be difficult to know when the claim would begin to run, and to know what the claim is, cannot be reconciled with the statutory standard that the insurer should have all information necessary to prove the policyholder's loss.

Through a reasoned analysis, the court in *Dallas Basketball* concluded that 21.55 does not apply to the duty to defend. Although other Texas courts have reached a contrary result, this Court should give weight to the *Dallas Basketball* court's decision because of its well-reasoned analysis. The court properly points out the unworkability of applying the statute to attorney's fees stemming from the duty to defend.

Courts in other jurisdictions confronted with this question also have determined that claims for defense costs are third-party claims. Construing a statute awarding attorney fees for failure to pay for first-party coverage, the Supreme Court of New Mexico ruled that non-payment of attorney fees in an underlying action filed by a third party does not constitute a failure to pay first-party coverage. *Amica Mut. Ins. Co. v. Maloney*, 903 P.2d 834, 842 (N.M. 1995). The statute at issue in *Maloney* provided:

In any action where an insured prevails against an insurer who has not paid a claim on any type of first party coverage, the insured person may be awarded reasonable attorney's fees and costs of the action upon a finding by the court that the insurer acted unreasonably in failing to pay the claim.

Id. at 841-42 (quoting N.M. Stat. § 39-2-1). The court concluded that the claim had been paid, and that equitable principles govern the payment of attorney's fees in the underlying action, as opposed to the statute. *Id.* at 842.

Numerous courts have recognized that a first-party claim is one for the direct benefit of the policyholder, while a third-party claim will often include claims such as the refusal to provide a defense. *Schwartz v. State Farm Fire and Cas., Co.*, 106 Cal. Rptr. 2d 523, 530 n.6 (Cal. App. 2001). The Supreme Court of Colorado has made the same observation. *Goodson v. Am. Standard Ins. Co.*, 89 P.3d 409, 414-15 (Colo. 2004) (“Third-party bad faith arises when an insurance company acts unreasonably in investigating, defending, or settling a claim brought by a third person against its insured under a liability policy.”); *see also Minn. Ins. Guar. Assoc. v. Integra Telecom, Inc.*, 697 N.W.2d 223, 230 n.2 (Minn. Ct. App. 2005) (“First-party claims are claims where the insured itself has a loss that is covered by a policy. In contrast, third-party claims are those where the insured is covered for liability to third persons.”).

Both Texas law and law from around the country agree that claims for attorney's fees stemming from the duty to defend, like the presence of a duty to defend itself, are necessarily third-party claims. Because article 21.55 is limited to first-party claims by a policyholder, this Court should rule that it does not apply to the duty to defend. A different rule would blur the lines between third-party coverage and first-party coverage.

General liability policies, like the one at issue here, plainly provide third-party coverage. Accordingly, article 21.55 is inapplicable.

CONCLUSION

For the foregoing reasons, the Complex Insurance Claims Litigation Association believes this Court should answer the certified questions in the negative, ruling that damage or loss of use of the home itself does not constitute an occurrence, that damage or loss of use of the house itself does not constitute property damage, and article 21.55 does not apply to a breach of the duty to defend.

Respectfully submitted,

WILEY REIN & FIELDING LLP
Laura A. Foggan
John C. Yang
1776 K Street, NW
Washington, DC 20006
(202) 719-7000 (phone)
(202) 719-7049 (fax)

Of Counsel

Wade Crosnoe
State Bar No. 00783903
THOMPSON, COE, COUSINS &
IRONS, L.L.P.
701 Brazos
1500 Austin Centre
Austin, Texas 78701
(512) 703-5078 (phone)
(512) 708-8777 (fax)

*Counsel for Amicus Curiae
Complex Insurance Claims
Litigation Association*

CERTIFICATE OF SERVICE

I hereby certify that on this 17th day of January, 2006, an original and eleven (11) copies of the Complex Insurance Claims Litigation Association *Amicus Curiae* Brief in Support of Mid-Continent Casualty Company were served by hand-delivery on:

Andrew Weber, Clerk
Supreme Court of Texas
201 W. 14th Street, Room 104
Austin, Texas 78701

and I further certify that a copy of the Brief was served by certified mail on the following counsel of record:

Lee H. Shidlofsky
Nickens Keeton Lawless Farrell & Flack LLP
327 Congress Avenue, Suite 490
Austin, Texas 78701

Attorneys for Lamar Homes, Inc.

Patrick J. Wielinski
Cokinos, Bosien & Young
221 E. Lamar Blvd., Suite 120
Arlington, Texas 76006

Amicus Curiae, American Subcontractors
Association, Inc. and ASA of Texas, Inc.

Geoffrey R. Unger
DLA Piper Rudnick Gray Cary US, LLP
1221 S. Mopac Expressway, Suite 400
Austin, Texas 78746

Amicus Curiae, National Association of Home
Builders

Richard P. Hogan, Jr.
Jennifer B. Hogan
Pillsbury Winthrop Shaw Pittman, L.L.P.
Two Houston Center
909 Fannin, 22nd Floor
Houston, Texas 77010

Attorneys for Mid-Continent Casualty
Company

E. Thomas Bishop
Bishop & Hummert, P.C.
1600 Premier Place
5910 N. Central Expressway
Dallas, Texas 75206

Amicus Curiae, Property Casualty Insurers
Association of America

Wade Crosnoe

CERTIFICATE OF COMPLIANCE

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 - c. The Type of Brief: Brief of Amicus Curiae Complex Insurance Claims Litigation Association in Support of Mid-Continent Casualty Company
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Wade C. Crosnoe
*Attorney for Amicus Curiae Complex Insurance
Claims Litigation Association*

Thompson, Coe, Cousins & Irons, L.L.P.
Texas Bar No. 00783903
701 Brazos
1500 Austin Centre
Austin, Texas 78701