



**Recent Texas Appellate Opinion Impacting Coverage:
Does General Liability Insurance Now Function as a Performance Bond?**

We had previously advised you of the 2 June 2005 opinion issued by the Texas Court of Appeals (Fourteenth District – Houston) styled *Lennar Corporation, et al. v. Great American Insurance Company, et al.* The opinion holds, in part, that:

1. A third-party claim against an insured for defective construction, based upon breach of contract, can constitute an “occurrence” as long as the resulting damage was unexpected and unintended, and does not fall within the policy’s “business risks” exclusions.
2. The standard ISO Exclusion 2.b for breach of contract does not apply to an insured’s breach of a contract to which the insured is a party.

In reaching the conclusion that a claim for breach of a construction contract can fall within the definition of “occurrence,” the court attempted to distinguish recent Texas appellate court opinions which have held that defective construction, based on breach of contract and tort, cannot constitute an occurrence as a matter of law. *Hartrick v. Great Am. Lloyd’s Ins. Co.*, 62 S.W.3d 270 (Tex. App.—Houston [1st Dist.] 2001, no pet.); *Malone v. Scottsdale Ins. Co.*, 147 F. Supp. 2d 623 (S.D. Tex. 2001); *Devoe v. Great Am. Ins.*, 50 S.W.3d 567 (Tex. App.—Austin 2001, no pet.). The court acknowledged, but distinguished, the opinion of *Jim Johnson Homes, Inc. v. Mid-Continent Casualty Co.*, 244 F. Supp. 2d 706 (N.D. Tex 2003), which held that a liability policy is not meant to function as a performance bond and ensure that the insured will perform its construction contract in a workmanlike manner and in accordance with the terms of the contract.

The Houston Fourteenth Court of Appeals reasoned that insurers should eliminate coverage for claims of defective work through application of the “business risks” exclusions and not through a restrictive interpretation of the “occurrence” definition. The court draws heavily on the opinion issued by the Wisconsin Supreme Court in *American Family Mutual Ins. Co. v. American Girl, Inc.*, 673 N.W.2d 65 (Wis. 2004).

The *American Girl* opinion held that:

If ... losses actionable in contract are never CGL “occurrences” for purposes of the initial coverage grant, then the business risk exclusions are entirely unnecessary. ... If the insuring agreement never confers coverage for this type of liability as an original definitional matter, then there is no need to specifically



exclude it. Why would the insurance industry exclude damage to the insured's own work or product if the damage would never be considered to have arisen from a covered "occurrence" in the first place?

American Girl, Inc., 673 N.W.2d at 78.

The court's analysis of Exclusion 2.b is much shorter than the analysis of the "occurrence" definition. The court merely states that this exclusion "precludes coverage when the insured assumes responsibility for the conduct of a third party," such as a contractual indemnity and hold harmless provisions. In essence the court limited Exclusion 2.b to contractual indemnity agreements. The court cited to *Federated Mutual Ins. Co. v. Grapevine Excavation, Inc.*, 197 F.3d 720 (5th Cir. 2001); *Insurance Co. of N. America v. McCarthy Bros. Co.*, 123 F. Supp. 373 (S.D. Tex. 2000); and *Olympic Inc. v. Providence Washington Ins. Co.*, 648 P.2d 1008 (Alaska 1982).

It appears that the court's analysis is circular in nature – it maintains that Exclusion 2.b applies only to contractual indemnity agreements and ignores the fact that this same Exclusion contains an exception for "insured contracts" which are defined to include:

That part of any other contract or agreement pertaining to your business under which you assume the tort liability of another to pay damages because of "bodily injury" or "property damage" to a third person or organization ...

Clearly, it is inconsistent and illogical to interpret Exclusion 2.b in this manner.

Exclusions for liability based on breach of contract are common in CGL policies, and Texas courts have enforced some of these exclusions. *See Pennsylvania Pulp & Paper Co. v. Nationwide Mut. Ins. Co.*, 100 S.W.3d 566 (Tex. App.—Houston [14th Dist.] 2003, pet. denied) (enforcing a breach of contract exclusion in an advertising injury coverage provision contained in a CGL policy and denying coverage for breach of contract claims asserted against the insured); *Sport Supply Group, Inc. v. Columbia Cas. Co.*, 335 F.3d 453 (5th Cir. 2003) (applying Texas law and enforcing a breach of contract exclusion in an advertising injury coverage provision in a CGL policy); *Nutmeg Ins. Co. v. Clear Lake City Water Auth.*, 229 F. Supp. 2d 668 (S.D. Tex. 2002) (contract liability exclusion precluded coverage for claims of breach of contract). In addition, insurance treatises have recognized that Exclusion 2.b is not restricted to contracts for contractual indemnity; *see also* ALLAN D. WINDT, 2 INSURANCE CLAIMS & DISPUTES: REPRESENTATION OF INS. COS. & INSUREDS, § 11:7A (2005 Supp.); FIRE, CAS., & SUR. CONTRACT ANALYSIS (September 2001). Unfortunately, there are no reported opinions from the Texas appellate courts or the Texas Supreme Court that address the scope and application of Exclusion 2.b.



Obviously, if the Fourteenth Court of Appeals' interpretation of Exclusion 2.b, as set forth in the *Lennar* opinion, becomes the law in Texas, property damage and personal injury resulting solely from the insured's breach of contract, may be covered under most general liability policies that employ language similar to Exclusion 2.b. The impact of such a development on liability insurers and their insureds would be significant.

The Houston Fourteenth Court of Appeals' opinion conflicts with existing Texas case law and a petition for rehearing has been filed with the Fourteenth District Court of Appeals. If the *Lennar* opinion is not overturned on rehearing, we anticipate that the *Lennar* opinion will go to the Texas Supreme Court on this issue.

We will continue to monitor this case as the motion for rehearing is considered and shall update our Legge Farrow Newsletters as developments warrant. If the Fourteenth Court of Appeals does not withdraw or significantly change its current opinion, we anticipate that a petition for review will be filed with the Texas Supreme Court. It is likely that a significant number of insurers will be filing *amicus curiae* briefs in either instance.

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