

Journal of Texas Insurance Law

OFFICIAL PUBLICATION OF THE INSURANCE LAW SECTION OF THE STATE BAR OF TEXAS



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- **An Explanation of Captive Insurance Arrangements from Formation to Ongoing Compliance**
- **So You've Got A Verdict... What Now?!**

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The Journal of Texas Insurance Law is published by the Insurance Law Section of the State Bar of Texas. The purpose of the *Journal* is to provide Section members with current legal articles and analysis regarding recent developments in all aspects of Texas insurance law and convey news of Section activities and other events pertaining to this area of law.

Anyone interested in submitting a manuscript for publication should contact Matthew Paradowski, Editor In Chief, at (214) 665-0137 or by email at matthewp@tbmmlaw.com. Manuscripts for publication must be typed and double-spaced with endnotes. Replies to articles published in the *Journal* are welcome.

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The Insurance Law Section serves to promote the understanding and development of Texas insurance law by providing high quality educational resources to the bench, bar, and public and by promoting collegiality among those with an interest in insurance law.

FROM THE EDITOR

By: **MATTHEW PARADOWSKI**, Tollefson Bradley Mitchell & Melendi, LLP

It is an honor to begin my term as Editor in Chief of the Journal and to help bring the latest edition to fruition. I would like to thank my predecessor Jason McLaurin and each of the preceding Chiefs for making the Journal an excellent publication and a must-read for Texas insurance practitioners.

This issue delivers what I admire about the Journal's work: a breadth of topics, excellent analysis and information that most readers would not come across in their day-to-day practice. Stewart Hale's explanation of the captive insurance industry is an example—Hale's article involves a detailed discussion of virtually every component of the captive insurance industry, from its history and purpose to its ever-expanding role in the modern insurance market.

We are also excited to deliver Patrick Wielenski's tome on commercial general liability coverage for construction defects. Be sure to clear your afternoon for this one—and keep a copy by your desk as an ongoing reference.

Lastly, William McMichael's award-winning article on post-verdict practice deftly synthesizes the issues and practical steps for insurance practitioners following verdicts and judgments.

My sincere thanks to the Journal's Managing Editors Matthew Rigney, Darin Brooks, and Christina Culver, as well as all the Associate Editors and contributors to this issue. We all appreciate the members of the Insurance Law Section who make our ongoing work here possible.

Matthew Paradowski
Editor in Chief

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CURRENT STATUS OF CGL COVERAGE FOR CONSTRUCTION DEFECTS IN TEXAS

By: PAT WIELINSKI

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I. INTRODUCTION

Disputes often arise as to whether a particular property damage claim arising from defective construction work implicates CGL coverage, builders risk coverage, professional liability coverage, a combination, or none of these. For these reasons, and others, construction-related claims frequently lead to coverage disputes under CGL policies between insurers and policyholders and between CGL insurers and other insurers. Such disputes can be complex and costly to resolve. With a particular emphasis on Texas law, this article discusses how CGL insurance applies to third-party property damage claims that arise either during construction or after construction operations have been completed. This article also includes other frequently encountered CGL insurance issues as applied to the Texas construction industry. It also emphasizes the big picture as to how those issues fit into the patchwork of court treatment throughout the United States.

Insurance coverage for defective work and resultant damage is the most frequently disputed CGL issue in the construction context. Since builders risk policies generally exclude coverage for defective work and design, owners, developers, and contractors may look to CGL policies for coverage. However, insurers often take the position that such claims are business risks expressly excluded from CGL coverage or that such claims arise from factors under the control of the insured and therefore fall outside the scope of CGL coverage. Disputes also arise as to whether certain types of damage alleged in such claims fall within the scope of property damage as defined by CGL policies. These issues are a particular focus in this discussion.¹

II. INTERPRETING THE LANGUAGE OF A CGL POLICY

Standard rules of contract interpretation apply to CGL policies, whether written for construction companies or other commercial ventures. These rules include principles that are applied specifically in the context of insurance coverage disputes—for example, policies must be read as a whole so that all parts of a policy are given effect and policy language is to be given its plain and ordinary meaning.²

An example of a court giving effect to all terms of the policy is *Country Pool & Spas, Inc. v. Erie Ins. Exchange*.³ In *Country Pool*, the plaintiff owner alleged the insured misrepresented that it would not need permits to perform work on the plaintiff's home. The insured tendered the suit to its insurer, who denied the claim. The trial court granted summary judgment for the insured, relying on the policy definitions for "your work" and "your product." The superior court reversed, finding that

"your work" and "your product" had no bearing on the meaning of "occurrence" in the policy's grant of coverage because they were contained only in the provisions excluding coverage; they were not used in the provisions extending coverage.⁴ Because there was no connection between the definition of "your work" or "your product" and "occurrence," the "your work" and "your product" definitions were not relevant to determining whether a misrepresentation was an intentional act, and thus not an occurrence under the policy.⁵

Another rule is that extrinsic evidence is allowed to interpret the policy where policy language is ambiguous.⁶ Only when, after applying the applicable rules of construction, a contract term is susceptible of two or more reasonable interpretations will the term be deemed ambiguous.⁷ If ambiguous, the interpretation affording coverage will be adopted, even if the insurer's interpretation may be more reasonable.⁸

For example, ambiguity may be injected into the CGL policy when manuscript endorsements are attached to the policy. In *ZZZ Carpentry, Inc. v. Mt Hawley Ins. Co.*,⁹ the court considered the scope of coverage for ZZZ's claim in light of a provision that classified ZZZ as "General Contractor—Interior" and excluded coverage for property damage or bodily injury arising out of "exterior work on exterior work projects above ground floor." The insured argued that the exclusion applied only to bodily injury or property damage stemming from exterior work, while the insurer argued that it applied any time the work involved exterior work. Finding both interpretations reasonable, the appellate division resolved the ambiguity in favor of the insured.¹⁰

The standard CGL policy contains a broad insuring agreement that grants coverage for all sums the insured is legally obligated to pay as damages because of bodily injury or property damage caused by an occurrence, as defined in the policy.

Although the insuring agreement is a broad grant of coverage, the policy shifts certain risks back to the insured through exclusions.¹¹ The CGL exclusions that garner the most attention in the construction context are those that address property damage claims, often referred to as the business risk exclusions. The evolution of these exclusions and their exceptions is essential to the overall analysis of CGL coverage for construction-related claims. CGL coverage for construction-related property damage most often turns on the applicability of these exclusions, rather than the broad insuring agreement and accompanying definitions.

III. THE HISTORICAL DEVELOPMENT OF THE CGL FORMS AND COVERAGE FOR DEFECTIVE WORK

A construction lawyer's first involvement with coverage issues may occur only after a claim has been made against the client and has been forwarded to an insurance carrier. Following notice, the insurer almost always issues a letter from the adjuster assigned to handle the claim. The letter may take several forms: an outright denial of coverage, an acceptance of coverage without reservation (rare), a reservation of rights letter, a request for more information, or a letter containing elements of some or all of these positions. In the majority of cases involving property damage to some part of a project (as opposed to, for example, damage to a neighboring structure), the insurer will assert or suggest that construction defects themselves are not covered because they are not property damage caused by an occurrence, or that only damage resulting from a construction defect is covered. The majority of CGL coverage disputes in the construction context spring from this scenario in some way.

At the outset of any coverage dispute, consideration and understanding of the historical development of the standard CGL policy is important. The CGL policy form has been in a state of continuing development for decades, including major revisions in 1966, 1973, and 1986. Courts hearing construction defect disputes have been particularly amenable to considering the historical development of CGL forms to determine the scope of coverage under present-day policies. This development reflects the efforts of the insurance industry to meet the perceived needs of the construction industry and to clarify and modify coverage as new risks have emerged. However, it also illustrates that when emerging, difficult-to-predict risks have resulted in unanticipated exposures for contractors and insurers, contractions of coverage have resulted. Examples include (relatively) new exclusions of exposures such as pollution, asbestos, fungus and mold, lead, exterior insulation and finish system (EIFS) and residential.

A. Business Risk and Revisions of the Forms

Tension has long existed between the underwriting of CGL coverage for damage to the work caused by an insured contractor and what underwriters traditionally have referred to as an uninsured "business risk." The drafting of CGL forms over the past 60 years reflects an effort by the insurance industry to provide a quantum of coverage for certain construction risks, including defective construction. "Fortuity" must underpin all insurance. However, in determining whether a certain type of loss is sufficiently fortuitous to be insurable, there

can be a fine line between uncertainty and foreseeability. Many disputes regarding coverage for defective work and resultant damage hinge on such fine distinctions. The drafters of the standard CGL form have attempted to address the concept of uninsured business risk primarily through exclusions and exceptions that have been modified over several years.

The standard CGL policy form is promulgated by the Insurance Services Office (ISO), an industry organization that drafts many standard forms used by insurers, including the primary ISO CGL occurrence form, CG 00 01. Over the years, the ISO CGL form has undergone several major revisions, including revisions affecting coverage for construction risks. One such revision was issued in 1966, when exclusion (o) (the "work performed" exclusion) was added to the policy to broadly exclude coverage for property damage arising out of "work performed by or on behalf of the named insured." This formulation excluded coverage for property damage arising out of the insured's work *and* work performed by subcontractors on the insured's behalf. However, in recognition of the nearly blanket nature of the exclusion vis-à-vis damage to the work, two companion endorsements were made available in 1969. One endorsement expanded coverage to include ongoing operations, and the other expanded coverage to include both ongoing operations and completed operations. Exclusion (o) was retained in the 1973 revision of the form, and the two endorsements also were retained to modify exclusion (o). For a time, the endorsements became collectively known as the broad form property damage endorsement. Another endorsement providing only ongoing operations coverage became separately known as advisory endorsement 3006 (excluding completed operations). The endorsement providing both ongoing operations and completed operations coverage became separately known as advisory endorsement 3005 (including completed operations).¹²

Endorsement 3005 was overwhelmingly more popular endorsement in the construction industry and eventually came to be referred to simply as the "Broad Form Property Damage Endorsement" (BFPDE). Indeed, construction contracts sometimes still refer to the BFPDE, even though its coverage was long ago incorporated into the main CGL policy form, as discussed below. The BFPDE expanded the coverage under the 1973 version of the main CGL form by, among other things, modifying the work performed exclusion to delete the reference to work performed on behalf of the named insured. As a result, coverage included property damage arising out of work performed by subcontractors.

The CGL policy form underwent another major revision in 1986. The 1986 revisions were widely hailed throughout the insurance industry, both for their simplification and reduction of the number of forms, as well as their use of more plain language. One simplification sought by ISO was to clarify the limitations on the business risk concept introduced in 1973 by the BFPDE. Because of the popularity of the extra coverage provided by the BFPDE, one major revision to the main CGL form was to add an exception for subcontractor work to exclusion (l) (the “your work” exclusion). This key exception states that the “your work” exclusion does not apply to work performed on the named insured’s behalf by a subcontractor. The 1986 revisions also rewrote and streamlined exclusions (j), (k) and (m), which apply primarily to risks that may relate to construction operations and loss of use damages (as discussed further below). References to the standard form CGL throughout this paper are to the current 2013 form, CG 00 01 04 13, © ISO Properties, Inc., 2012. The provisions of that form are substantially identical to those included in the standard ISO form since 1986. For a more detailed discussion of the development of CGL forms as applied to the construction industry dating back to the 1950s, see PATRICK J. WIELINSKI, *INSURANCE FOR DEFECTIVE CONSTRUCTION*, Chapters. 1, 11 (6th ed. 2023).

B. CGL Coverage Versus Performance Bonds

Insurers often argue that providing liability coverage for such construction defect damages would impermissibly convert CGL policies into performance bonds.

Of course, a performance bond is not insurance, and vice versa. Insurance is an indemnity contract, while a surety bond is a guaranty of the principal’s performance obligations. An insurance policy is issued based on an evaluation of risks that are actuarially linked to premiums. Expected losses (sometimes referred to as “loss picks” by underwriters) are determined in advance. In contrast, a surety bond is underwritten based on what amounts to a credit evaluation of the contractor and its capabilities to perform with the expectation that no losses will occur. As part of the underwriting of a bond, the surety analyzes the strengths and weaknesses of the contractor, its financials, and its ability to perform its obligations. The process is similar to that used by a lender in making a loan. In addition, the performance bond is not for the protection of the contractor (the principal), but rather for the protection of the owner (the obligee).

Recent cases such as *United States Fire Ins. Co. v. J.S.U.B., Inc.*,¹³ and *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*,¹⁴ have addressed the distinctions between

these two types of instruments. In *Lamar Homes*, the Supreme Court of Texas concluded that any similarities between CGL coverage and a performance bond under the circumstances of a subcontractor defect claim were irrelevant to the CGL policy’s coverage and that no rule of policy construction eliminates coverage merely because similar protection may also be available through another product.¹⁵

As noted above, a performance bond is a three-party instrument between the obligee, the surety, and the contractor, with the surety retaining an indemnity right against the contractor and other indemnitors, typically the contractor’s individual owners. Thus, the contractor will ultimately have to pay by indemnifying the surety for amounts paid to or for the benefit of the obligee. This is a fundamental distinction between performance bonds and CGL coverage: an insurance company has no right of indemnity against its insured for covered losses. An insurer is instead limited to recover against third parties through subrogation (to the extent allowed by the insurance policy or separate subrogation waivers).

One of the assumptions behind the argument that CGL coverage should be limited where it would subsume certain obligations under a performance bond is that the scope of a performance bond and a CGL policy must be mutually exclusive. While there are many types of risks and losses that fall within the ambit of a bond and not an insurance policy, and vice versa, there can be considerable overlap between the two.

For example, assume that a residential condominium building is constructed with defective balconies that slope backward toward the building. Defective waterproofing and flashing that allow water to enter finished units compound the problem. The plans and specifications called for a proper slope and proper waterproofing and flashing, but the general contractor used a subcontractor that failed to perform as required. If the general contractor does not fix the defects after a request from the developer (the surety bond obligee), it may trigger a performance bond default and the surety’s obligation to remedy the work. In that case, the surety would usually cover the cost of removing and rebuilding the balcony (some of which may be treated as covered rip-and-tear work under a CGL policy). Resultant damage to unit owner build-outs outside the scope of the contractor’s work would likely not be covered by the performance bond but might be covered under the contractor’s CGL policy. Upon payment to the owner of a performance bond claim involving defective workmanship, the surety would have a right of indemnification against the principal-contractor

and would be subrogated to the contractor's rights under its CGL policy. A surety's right of subrogation against its principal's CGL insurer is well recognized.¹⁶

Some courts continue to find that CGL coverage for defective workmanship is generally barred because to hold otherwise would convert the policy into a performance bond.¹⁷ Overall, however, the argument is waning as an independent basis to deny CGL coverage for defective workmanship claims, even in states that previously followed that approach.¹⁸

IV. THE CGL INSURING AGREEMENT

An analysis of coverage under any insurance policy, including a CGL policy, begins with the insuring agreement. The insuring agreement sets forth the scope of coverage without regard to exclusions and conditions. As noted above, the CGL's insuring agreement is broad. The Coverage A insuring agreement of a standard CGL policy applies to bodily injury and property damage liability.¹⁹

Coverage A provides, in part:

We will pay those sums that the insured becomes legally obligated to pay as damages because of "bodily injury" or "property damage" to which this insurance applies.

* * *

This insurance applies to "bodily injury" and "property damage" only if:

- (1) The "property damage" is caused by an "occurrence" that takes place in the "coverage territory"; [and]
- (2) The "bodily injury" or "property damage" occurs during the policy period.

* * *

Although the insuring agreement contains other provisions that apply to the scope and duration of the coverage, the first sentence frames the broad scope of coverage. It states the policy covers all sums the insured becomes "legally obligated to pay as damages . . . to which the insurance applies," that is, bodily injury or property damage that takes place during the policy period and is caused by an occurrence. The component parts of the CGL insuring agreement each have their own legal significance.

A. Legal Obligation

As noted above, the insuring agreement applies to sums the insured becomes legally obligated to pay as damages. Satisfaction of the "legally obligated" requirement can be a source of disagreement between insureds and insurers. One issue is whether damages for breach of contract—in the absence of a judgment—give rise to the legal obligation contemplated by the insuring agreement. The issue is particularly significant in the construction context, where contractual relationships usually govern every facet of a project.

One frequently cited case for the proposition that liability for breach of contract does not satisfy the "legally obligated" requirement is *Data Specialties, Inc. v. Transcontinental Ins. Co.*²⁰ In this case, the insured electrical contractor sought coverage for damage to the electrical system that exploded while the insured was repairing it. The court held that in the absence of a judgment against it, the insured was not legally obligated to pay the damages. The court relied primarily on California precedent that was later overruled and discredited by the California Supreme Court in *Vandenberg v. Centennial Insurance Co.*²¹ In *Vandenberg*, the California Supreme Court expressly held that the phrase "legally obligated to pay as damages" in the CGL insuring agreement should be given its plain and ordinary meaning, and not one drawing an overly formal distinction between tort and contractual liability. The case law the California Supreme Court overruled was based upon a misreading of an early case, which interpreted a policy with an insuring agreement that expressly distinguished between liability imposed by law and liability by written contract.²²

Nevertheless, other courts have adhered to the tort-versus-contract distinction. For example, the court, in *McDonald Construction Co., Inc. v. Bituminous Cas. Corp.*,²³ held that the cost of replacing floor tiles was not covered under a CGL policy because the cost arose from the insured's preexisting contractual obligation and not a tort claim for damage to the tiles.²⁴ Therefore, the insured was not legally obligated to replace the tiles. Other courts have reached similar conclusions.²⁵

However, this distinction continues to lose favor. More recent opinions hold that liability arising out of breach of contract can give rise to damages for which the insured is legally obligated. In *Wanzek Construction, Inc. v. Employers Ins. of Wausau*,²⁶ the court determined that the cost of repairing defective coping stone on a swimming pool was within the insured's contractual obligation to repair or pay for property damage to the project. The court found that nothing in the CGL insuring agreement

suggested a lawsuit was necessary to trigger coverage.²⁷ Under Texas law, in *Venture Encoding Service, Inc. v. Atlantic Mutual*,²⁸ the insured printer was obligated under the terms of its contract to remedy printing errors and was legally obligated to pay expenses within the terms of its liability policy. For a further example, in *Lennar Corp. v. Great American Ins. Co.*,²⁹ the court recognized the insured builder's legal obligation to pay to repair a defective exterior insulation finishing system (EIFS) and noted that a judgment is not the only manner by which an insured can become legally obligated to pay.³⁰ The court reasoned that a legal obligation can be imposed by law, pursuant to a judgment, settlement, contract, or statute.³¹

The tort-versus-contract limitation on the "legally obligated" requirement has been rejected by some courts because it lacks support in the policy's language. Early commentary from the insurance industry as to the "legally obligated" requirement indicates that the coverage grant is broad enough to include the insured's legal obligation to pay damages for breach of contract as well as for tort, subject to other limitations of the policy, including the definitions of property damage and occurrence and the exclusions.³² It should be noted that despite limited success with the tort-versus-contract dichotomy as to the insuring agreement's "legally obligated" formulation, insurers frequently also have raised the same type of argument as to the definition of occurrence. That issue is addressed below.

Ultimately, the tort-versus-contract distinction in the CGL insuring agreement is based on a false premise, particularly in the construction industry where the economic loss rule may preclude a tort claim from being asserted.

B. Right to Repair Laws

Many states, including Texas, have enacted right to repair laws that place procedural restrictions on, or serve as predicates to, the ability of homeowners to file construction defect lawsuits against builders or contractors. Homeowners who seek to hold builders and contractors responsible for repairing defects homes must comply with right to repair statutes. The statutes typically set out the following procedural prerequisites for a homeowner to file suit: (a) statutory notice to the builder of the defect; (b) opportunity for the builder to inspect the alleged defect; and (c) opportunity for the builder to repair the defect. The homeowner may file a traditional construction defect lawsuit only after compliance with these requirements. Insurance issues include whether the receipt of a right to repair notice triggers the duty to defend the contractor and whether the right to repair proceeding seeks damages that the insured contractor is legally obligated to pay.

In *Lennar Corp. v. Markel Am. Ins. Co.*,³³ the Supreme Court of Texas declined to resolve these issues under the Texas Residential Construction Liability Act (RCLA).³⁴ The court determined that it did not need to rule on whether settlements made pursuant to RCLA triggered coverage under the insured's CGL policy. The court had already decided that the insured was entitled to coverage because the insurer was not prejudiced by the insured's voluntary settlement of EIFS claims, so considering whether voluntary proceedings were legal obligations under RCLA was unnecessary.³⁵

So far, only a limited number of courts have addressed these, but a significant opinion on that issue originating in the Southern District of Florida is *Altman Contractors, Inc. v. Crum & Forster Specialty Ins. Co.*³⁶ The case went up on appeal to the Eleventh Circuit, in *Altman Contractors, Inc. v. Crum & Forster Specialty Ins. Co.*,³⁷ and that court certified the question of the duty to defend a right to repair proceeding under Fla. Stat. Ch. 558 to the Florida Supreme Court.³⁸

At the center of the dispute was whether an alternative dispute resolution proceeding in which such damages are claimed and to which the insured submits with the insurer's consent met the definition of "suit" in the standard CGL policy. The court held that the right to repair proceeding fell under definition of "suit," but remanded the case to the Eleventh Circuit to determine whether the insurer had consented to the insured's participation in the proceeding, which went full circle, remanding it back to the trial court from whence it came.³⁹ A number of cases provide opposite results.⁴⁰

Some states have also addressed the effect of receipt of a right to repair notice by statute. Even a general discussion of the nuances of these many and varied statutes is beyond the scope of this paper, and the obvious conclusion is that the applicable state's right to repair law must be carefully reviewed.⁴¹

C. "Because Of" and the Insuring Agreement

A key provision in the CGL insuring agreement states the insurer will pay damages the insured is legally obligated to pay "because of" bodily injury or property damage. The "because of" formulation is a basis for insureds to recover the costs to repair property damage (defined, in part, as "physical injury to tangible property") to the project and other consequential damages. A case that extensively discusses this issue is *Lennar Corp. v. Great American Ins. Co.*,⁴² in which the insured homebuilder sought coverage for the cost to repair water damage to hundreds of homes due to defective EIFS. The court determined that damage arising out of the water

infiltration through the defective EIFS caused property damage, and the costs of repairs were damages incurred “because of” that property damage. However, the court held that the costs to remove EIFS on undamaged homes as a preventive measure were not covered because they did not constitute damages paid by the insured because of property damage.

The *Lennar* case has a lengthy and complex procedural history that culminated in the Supreme Court of Texas’s 2013 decision.⁴³ That case primarily dealt with other issues but added clarity as to damages “because of” property damage. Lennar argued that it could not determine the areas of water damage without completely removing the EIFS. Therefore, the costs to remove all the EIFS were covered as damages “because of” property damage. Lennar conceded that there was no coverage for removal of EIFS that ultimately revealed no water damage. The excess insurer, Markel, argued that all costs for removal of the EIFS were noncovered “preventative measures.” The court disagreed, holding that the phrase “because of property damage” necessarily included the cost of finding EIFS property damage to repair.

If damages “because of” property damage are broader than property damage itself, there is a basis for recovery of consequential damages so long as those damages were caused by property damage. A seminal case for this proposition is *American Home Assurance Co. v. Libbey-Owens Ford Co.*,⁴⁴ which involved a claim against the manufacturer of window glass where the alleged damages included the windows themselves. The court held that consequential losses from physical injury to the windows were covered, even though there may be no coverage for the repair and replacement of the windows themselves. The court remanded the case to the trial court to determine which of the claimed consequential damages, including increased administrative and heating/cooling costs and lost rentals, were due to the breakage of the insured’s windows.

Riley Stoker Corp. v. Fidelity & Guaranty Insurance Underwriters,⁴⁵ Inc. provides another example in which delay damages were awarded as damages “because of” property damage. Applying Louisiana law, the court upheld coverage for delay damages because of explosions and mechanical problems in connection with construction of two coal-fired steam generators.⁴⁶

V. “OCCURRENCE” AND RELATED REQUIREMENTS AND ISSUES

One of the most important requirements for coverage under a CGL policy is that the bodily injury or property

damage be caused by an occurrence. “Occurrence” is defined in the policy as “an accident, including continuous or repeated exposure to substantially the same general harmful conditions.” The definition of “occurrence” is the point where the CGL directly incorporates the requirement of fortuity, which is the basic tenet of insurance that an insured should not be able to control the risk and obtain insurance coverage for intentional acts. In *Cam-Sam Real Estate Holding, LLC v. Merchants Mut. Ins. Co.*,⁴⁷ the court recognized that an insured has less incentive to take precautions to prevent damage to its property if it has insurance to cover the damage in the context of applying the CGL policy’s owned or leased premises exclusion.

A. Historical Development of “Occurrence”

The CGL forms moved from a strict “accident” formulation to an occurrence basis in 1966. At that time, “occurrence” was defined as “an accident, including injurious exposure to conditions, which results, during the policy period, in bodily injury or property damage neither expected nor intended from the standpoint of the insured.” The 1973 revisions to the CGL policy form maintained that definition. In 1986, the definition of “occurrence” was added in its present iteration, and the “neither expected nor intended” language was moved to exclusion (a). The current exclusion states the insurance does not apply to “bodily injury or property damage expected or intended from the standpoint of the insured.” The current definition of “occurrence,” together with exclusion (a) in the policy form, tracks the 1973 definition in which the “neither expected nor intended from the standpoint of the insured” requirement was incorporated within the definition of “occurrence.”

The 1986 division of “occurrence” into a definition essentially defining the term as an accident, plus a separate exclusion, have had little effect on how the occurrence requirement is applied by the industry or interpreted by courts. For example, in *King v. Dallas Fire Ins. Co.*,⁴⁸ the court traced the evolution of the definition of “occurrence” set out above. The court concluded that there is a relationship between the definition of “occurrence” and the expected or intended acts exclusion and that the 1986 redraft was designed to shift and retain the intentional injury inquiry into an exclusion. In practical terms, issues relating to the fortuity of bodily injury or property damage arising out of construction risks are usually determined by reference to the occurrence requirement. Exclusion (a), if addressed at all, is usually relegated to tag-along status.

B. The Occurrence and Property Damage Conundrum

The issue of whether a contractor's defective work arises out of an occurrence has been hotly disputed in courts throughout the United States. The divergence in views of the occurrence requirement is one reason insureds must carefully analyze which state's law applies to a coverage dispute. The applicable state law is crucial in determining coverage and needs to be analyzed from the very outset of a claim.

As the number of opinions have increased in both number and diversity over the years, the trend is that inadvertent construction defects constitute an occurrence. By and large, the cases fall into several categories of approach.⁴⁹ The categories are as follows:

1. Defective work is not an occurrence.
2. Defective work is an occurrence, including coverage for the defective work itself, subject to the exclusions of the CGL policy. This is the law in Texas.
3. Resulting damage to property other than the defective work itself, including other work on the project, is an occurrence.
4. Resulting damage to third party property only, *i.e.*, to other than the work on the project itself, is an occurrence.
5. Case law is undecided or unclear.

Approach 1. As stated, most jurisdictions recognize construction defects as giving rise to an occurrence, with some jurisdictions recognizing the qualifications set out above. Nevertheless, a discussion of cases representing each view is helpful to an overall understanding of the issues. The leading case holding defective work cannot constitute an occurrence is *Kvaerner Metals Div. of Kvaerner U.S., Inc. v. Commercial Union Ins. Co.*,⁵⁰ In this matter, Kvaerner (the insured) agreed to build a brick oven battery according to a contract with Bethlehem Steel. The brick and masonry on the oven failed by shifting and cracking. As a result, Bethlehem sued Kvaerner for breach of contract. The Pennsylvania Supreme Court applied a strict eight-corners rule, holding that it could not look beyond the Bethlehem complaint and the policy to determine coverage. Strictly applying the breach of contract allegations, the court held that claims of faulty workmanship did not satisfy the definition of "accident" required to establish an "occurrence." It observed that such claims do not present the degree of fortuity contemplated by the ordinary definition of "accident" or

its common judicial construction. In the view of the court, to hold otherwise would be to convert the policy into a performance bond. The court concluded that, since the underlying suit alleged only property damage from poor workmanship to the work itself, there was no occurrence.

Pennsylvania courts have generally held to this position. In *Knoblich v. Erie Ins. Exchange*,⁵¹ the insured HVAC contractor installed a defective geothermal heating and cooling system that failed to maintain constant temperatures in a house. The insured and the owner sought coverage under the insured's CGL policy to remove and replace most of the duct work and to complete the system installation. The court held that under Pennsylvania law, particularly *Kvaerner Metals Div. v. Commercial Union Ins. Co.*,⁵² faulty workmanship did not constitute an occurrence, and the failure to install the geothermal system in a workmanlike manner in accordance with the manufacturer's specifications was a breach of the contract with the homeowners. Therefore, it was not an accident, *i.e.*, unexpected and fortuitous and, thus, there was no occurrence under the policy to trigger the insurer's duty to defend or indemnify. This case is one of a long line in which Pennsylvania courts have bucked the national trend, refusing to that unexpected and unintended property damage arising out of the insured's work is an occurrence. So far, there does not appear to be an indication if and when one of the last dominoes will fall in favor of the construction industry.

A limited number of other jurisdictions hold to this view, including the District of Columbia,⁵³ Wyoming,⁵⁴ and Hawaii.⁵⁵

Approach 2. A leading case that upholds that defective work can give rise to an occurrence, *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*,⁵⁶ is worth examining in-depth. That case involved a suit against an insured homebuilder arising out of a subcontractor's defective work. The builder's CGL insurer denied coverage on the ground that faulty workmanship is not an occurrence, and that to find otherwise would transform the CGL policy into a performance bond.⁵⁷ The case originated in federal district court, and the occurrence question was certified by the Fifth Circuit to the Supreme Court of Texas, which recognized that not every case of faulty workmanship will result in coverage.⁵⁸ The court noted situations where faulty workmanship is intentional from the viewpoint of the insured, and where faulty workmanship merely diminishes the value of the damaged project without causing physical injury.⁵⁹ The court also observed that some faulty workmanship claims would be excluded under specific "business risk" exclusions.

However, the court also reviewed the evolution of the CGL policy and concluded that the subcontractor exception to the your work exclusion was a purposeful addition to the CGL policy, recognizing the existence of an occurrence as to defective work that had to be given effect. The subcontractor exception applies to work performed for the named insured by subcontractors and is more extensively discussed below in connection with exclusion 1., the your work exclusion. The court rejected Mid-Continent's argument that the insured was using the subcontractor exception to create coverage.⁶⁰ Likewise, the court rejected any contract-versus-tort distinction for determining whether the occurrence requirement is satisfied.⁶¹

Similarly, the court rejected foreseeability as the boundary between accidental and intentional conduct.⁶² If foreseeability means no coverage, then CGL coverage is illusory. Insurance premiums are based on actuarial risk.⁶³ Put simply, the reason why consumers buy insurance is because of foreseeable risks. If CGL insurance protected only against unforeseeable risks, then it would be of little use to contractors.

A case of more recent vintage recognizing that defective work gives rise to an occurrence is *Acuity v. M/I Homes of Chicago, LLC*,⁶⁴ in which the insured sought CGL coverage for construction defects resulting in water damage to a townhome project. In that context, the Illinois Supreme Court clarified the law to agree with many states' law that such property damage is an "occurrence." The case was closely followed because for over twenty years, courts in Illinois interpreted the definitions of "property damage" and "occurrence" in the CGL policy to deny coverage for property damage arising out of defective construction as to the entire construction project itself. Those courts found a covered occurrence only in the unlikely event of damage to other real property, and perhaps to personal property of project owners, or a neighboring building. In reality, this amounted to little, if any, coverage for Illinois insureds, and Illinois lagged behind numerous other jurisdictions in upholding coverage for unexpected and unintended property damage arising out of faulty workmanship. That prior case law corresponds to Approach 4, discussed below. The Supreme Court of Illinois noted that such a narrow view of coverage is unsupported by the policy language, and it joined the majority of jurisdictions in holding that unexpected and unintended physical injury to tangible property arising out of defective work is an occurrence under a CGL policy.

The court further opined that once an occurrence of property damage is found, resort must be had to

the property damage exclusions within the policy to determine ultimate coverage, including exclusions relating to that particular part of property damage upon which work is being performed out of which the property damage arises; that particular part of real property that must be repaired or replaced due to incorrect work by the insured; property damage to the insured's work after completion (subject to an exception for work performed by the insured contractor's subcontractors); or impaired property or property that has not been physically injured (all of which are discussed later in this paper). In doing so, the Court rejected the notion that property damage arising out of defective workmanship amounts to an uninsurable "business risk," the cost of which is to be borne by the insured contractor itself. In many respects, the change under Illinois law in the status of unexpected and unintended construction defects from uninsured business risk to occurrence was regarded as one of the last dominoes to fall as to significant changes in state law on construction liability coverage.

Courts of other states have issued opinions concluding that claims against an insured contractor satisfy the "occurrence" requirement, including: Wisconsin,⁶⁵ Mississippi,⁶⁶ South Carolina,⁶⁷ Tennessee,⁶⁸ Kansas,⁶⁹ Indiana,⁷⁰ Alaska,⁷¹ Louisiana,⁷² Maine,⁷³ Michigan,⁷⁴ Minnesota,⁷⁵ Montana,⁷⁶ Nevada,⁷⁷ North Dakota,⁷⁸ Oregon,⁷⁹ South Dakota,⁸⁰ Vermont,⁸¹ Washington,⁸² and West Virginia.⁸³ Arkansas has attempted to address the issue by statute.⁸⁴

Approach 3. Shortly after *Lamar Homes* was decided, the Florida Supreme Court addressed a case involving an insured general contractor's claim involving damage to completed homes caused by its subcontractors' use of poor soil and improper soil compaction and testing.⁸⁵ In *U.S. Fire Ins. Co. v. J.S.U.B.*, the insurer argued that a subcontractor's faulty workmanship causing damage to the insured contractor's own work can never be an occurrence because it results in reasonably foreseeable damages.⁸⁶

The court, focusing on the evolution of CGL policy forms, rejected that analysis and instead found that the defective workmanship of a subcontractor can constitute an occurrence under a general contractor's CGL policy.⁸⁷ The court also rejected the insurer's contention that construing the term "occurrence" to include a subcontractor's defective work converts a CGL policy into a performance bond.⁸⁸ The Florida Supreme Court relied on previous case law holding that if the resulting damages to other than the defective work are unintended, those resulting damages are accidental even though the original acts were intentional.⁸⁹ Therefore, though the

court applied the standard formulation of occurrence—the existence of property damage neither expected nor intended from the standpoint of the insured—it, narrowed the scope of covered property damage to resulting work due to the defective workmanship.

This line of cases provides a middle ground approach between accepting the status of defective work as an occurrence and refusing to do so, thus compromising that damage to other work arising out of defective work constitutes an occurrence. Note that in doing so, these courts reach a conclusion that ignores the express definition of “occurrence” in the CGL policy, which makes no distinction between defective and other work. Numerous other courts follow this approach.⁹⁰

McLaughlin v. Gaslight Pointe Condo. Ass’n, LTD,⁹¹ is an example of well-intentioned actions—repairs of existing defects—gone awry that give rise to an occurrence of damage to other non-defective property. The owners of condominiums sued Gaslight, their condo association, for damage to their units that arose out of failure to adequately repair defective construction, supervise repair work, and hire qualified contractors. Gaslight’s insurer intervened in the suit and countersued for declaratory judgment that it had no duty to defend or indemnify. The insurer argued that Gaslight’s decisions regarding how to address the alleged damage did not constitute “occurrences” because they were not “accidents.” Gaslight cited several Wisconsin court decisions that involved deliberate decisions that courts ruled led to occurrences. The court agreed with Gaslight, that such a scenario was possible, emphasizing that the precedent establishes a pattern—“(1) an insured’s conduct leads to (2) an event that (3) causes damage”⁹²—and that such a pattern was present in the case at hand. The court particularly focused on decisions regarding the owners’ complaints of water intrusion, which led to property damage in the units. In analyzing whether the water intrusion into the units constituted an occurrence, the court highlighted that Gaslight took steps to repair the work and that there was no evidence that they expected the intrusion to continue. The court held that a reasonable juror could conclude that “Gaslight neither foresaw nor expected the damage to continue to the Owners’ units that followed its attempts to repair its building.”⁹³ The court reversed the district court’s finding that there was no coverage under the CGL policy.

Approach 4. Yet another permutation of “defective work as occurrence” is the approach that only damage to property separate and apart from the insured’s work, defective or not, can give rise to an occurrence. Under this more aggressive denial approach, only damage to true third-party property constitutes an occurrence. As

can be seen, this approach aligns with cases that hold that property damage arising out of defective construction can never constitute an occurrence, and instances where an occurrence would exist seem to be relatively rare. This was the situation faced by insureds under Illinois law prior to its abrogation by *Acuity v. M/I Homes of Chicago, LLC*,⁹⁴ discussed above in connection with Approach 2.

An example of this approach is *Lexicon, Inc. v. ACE Am. Ins. Co.*⁹⁵ There, the insured general contractor agreed to fabricate and erect new storage silos to store direct reduced iron (DRI) product. After several months of use, one of the silos collapsed when the bottom cone section gave way due to inadequate welding by the subcontractor. The DRI slid out of the silo and onto the ground for a considerable distance, resulting in loss of or damage to thousands of tons of product. Due to exposure to the atmosphere, the DRI became less metalized and less useful for steel making, with some of it burning similar to charcoal. Bound by Arkansas law, most notably, *Essex Ins. Co. v. Holder*⁹⁶, the Eighth Circuit determined that the damage to the silo itself was foreseeable; however, the damage to the iron ore product stored in the silo was not foreseeable. Therefore, the court held that damage to the silo was not an occurrence, but the collateral damage to the product and any nearby equipment lost in the collapse was an occurrence.⁹⁷

Results such as the *Lexicon* case reveal the infirmities of the resulting damage to third party property approach. In terms of foreseeability (and common sense), there is no rational distinction between damage caused to the collapsed silo versus damage to its contents and associated equipment. It strains the imagination to regard property damage to the contents of the collapsed silo, not the insured’s work, as not foreseeable, but at the same time to accept that damage to the silo, the work itself, arising out of the collapse is foreseeable, especially where the damage to the silo exceeded the damage to the product, both in the millions of dollars.

This approach persists in *Lessard v. Havens & Sons, Inc.*⁹⁸ In this matter, the insured homebuilder sought coverage from its CGL insurer for a judgment in excess of \$250,000 in damages for structural, roof, and siding defects in a home it constructed. The insurer intervened and sought a declaration that it did not have a duty to indemnify the insured, and the court agreed, holding that CGL policies provide coverage for tort liability for physical damage to others and not for contractual liability of the insured for economic loss. The replacement or repair of faulty goods and work is a business expense to be borne by the insured to satisfy its customers. The court rejected the argument that the damages were, at least in

part, for the cost of repairing property damage that the construction defects caused, not the costs of repairing or removing the construction defects themselves in that the structural defects caused cracks in the walls and defects in the roof deck and siding, and defects in the roof and siding caused water damage. However, neither the insured nor the homeowners identified any sums to repair the cracks or the water damage. Massachusetts remains one of a relatively small number of jurisdictions that, contrary to the definition of “property damage” in the CGL policy, limit coverage to only third-party property and deny coverage for damage to the work of the insured. Cases from other jurisdictions adhere to this approach.⁹⁹

Approach 5. The final approach is reserved for those states where the law appears undecided, unclear or may not exist. These states include:

Delaware – While case law exists for the proposition that faulty workmanship is not an occurrence in *Westfield Ins. Co., Inc. v. Miranda & Hardt Contracting & Building Servs., LLC*,¹⁰⁰ case law also applies the subcontractor exception to Exclusion 1 to preserve coverage for the insured contractor.

Hawaii – Hawaii Statute section 431:217 went into effect on June 3, 2011, a result of the concern created by the court’s opinion in *Group Builders v. Admiral Ins.*,¹⁰¹ which denied coverage for property damage arising out of construction defects. Nevertheless, as passed, the statute stated that “[t]he term ‘occurrence’ shall be construed in accordance with the law as it existed at the time the insurance policy was issued.”¹⁰² This provision leaves open the ultimate question of what “the law” is now or what “the law” was in the past. In *Nautilus Ins. Co. v. 3 Builders, Inc.*,¹⁰³ where an apartment owner association sued a roofing contractor for alleged defects in the new roofs, the court required the policy be interpreted in accordance with the law as it existed at the time the insurance policy was issued in 2008. The court found that *Burlington Ins. Co. v. Oceanic Design & Constr., Inc.*,¹⁰⁴ represented Hawaii law as it stood in 2008, and because all of the claims were either contract claims or claims that arose from the contract or the contractual relationship, there was no occurrence under *Burlington v. Oceanic*. Therefore, the value of the Hawaii legislation is highly questionable.

Idaho – No discernable trend.

Ohio – Ohio law remains unclear.¹⁰⁵

Oklahoma – Oklahoma case law is mixed.¹⁰⁶

Aside from the occurrence approach applied under various state laws, the development of more recent approaches to coverage, such as wrap-ups (controlled insurance programs) can affect the CGL insuring agreement. For example, in *Soule v. Woodward Design + Build, LLC*,¹⁰⁷ the general contractor sponsored a contractor-controlled insurance program for a condo construction project. One of its subcontractors did not complete its enrollment in the CCIP but paid premiums to the general contractor for CCIP coverage. After an elevator/hoist fell injuring several workers, the subcontractor tendered the claim to its corporate CGL insurer. The CGL policy contained an exclusion for work performed that “is or was to be insured under a consolidated (wrap-up) insurance program.” The court agreed with the insurer that the fact that the subcontractor failed to enroll properly in the CCIP was irrelevant to the interpretation of the corporate CGL policy. As a result, the subcontractor was left without insurance even though it had been paying premiums for both policies.

VI. TRIGGER OF COVERAGE

The concept of “trigger”—that is, when injury occurs that implicates coverage under a particular policy—is one of the thorniest concepts in CGL coverage. When bodily injury or property damage corresponds with a so-called “boom event,” it is relatively easy to determine which policy must respond to the loss. Construction property damage losses, however, often involve latent or progressive damage that occurs over time. In occurrence-based CGL policies, the insuring agreement specifically requires that the bodily injury or property damage take place during the policy period.

Thus, when the work was performed is not usually relevant. The timing of the resulting injury or damage (rather than the timing of the occurrence) determines which policy or policies must respond to a particular loss. The trigger analysis for occurrence-based policies has spawned several different approaches:

- (1) the “manifestation” trigger;
- (2) the “exposure” trigger;
- (3) the “actual injury” or “injury-in-fact” trigger; and
- (4) the “continuous” trigger.

It is dangerous to place labels on the different trigger theories because courts may apply them differently. What one court calls a manifestation trigger may be what another court calls an exposure trigger.¹⁰⁸ Trigger battles were commonplace in environmental coverage litigation

and other types of long-tail claims (most notably, asbestos-related claims), and the issue is also fertile ground for litigation in the construction defect arena.

Furthermore, even when a state's high court has issued an opinion adopting a particular trigger theory, the labels are somewhat malleable in nature. It is not uncommon for a court to apply a trigger theory to fit a particular set of facts. Moreover, it is more commonplace for CGL insurers to add policy language that impacts the trigger analysis (e.g., continuous and progressive damage exclusions, pre-existing damage exclusions, and prior work exclusions).

A. Manifestation Trigger

A manifestation trigger analysis considers damage to have occurred when it becomes apparent or readily identifiable. Although the manifestation trigger may be easier to apply, it is not widely followed in connection with liability coverage.¹⁰⁹

Courts generally hold that it is not grounded in the policy language.¹¹⁰ Even when a jurisdiction appears to adopt a manifestation trigger, a marked difference may exist as to how one court applies it versus another. Over time, the manifestation trigger has been rejected in most jurisdictions and is a minority view.

B. Exposure Trigger

Under an exposure trigger, coverage is triggered at the time of the exposure to the conditions that cause the damage. Although the exposure trigger has been applied with some frequency in bodily injury cases, especially in the asbestos context, it has not been widely followed in property damage cases.¹¹¹ One case that seemingly applies an exposure trigger in the liability context is *American Employer's Ins. Co. v. Pinkard Construction Co.*¹¹²

As with the manifestation trigger, an exposure trigger suffers from textual problems when applied to the policy language because a CGL policy does not state the coverage applies if property is, during the policy period, exposed to a process, event, or substance that later results in bodily injury or physical injury to tangible property.¹¹³ However, in practice, the nominal application of an exposure trigger often does not differ much from application of an actual injury or injury-in-fact trigger.¹¹⁴

C. Actual Injury or Injury-in-Fact Trigger

The actual injury or injury-in-fact trigger, as the name implies, attempts to match the policy with the time when the damage actually occurs. In contrast to a manifestation trigger, the policy language, which requires

that damage occurs during the policy period, supports this trigger theory. This trigger has been adopted by the Texas Supreme Court, which acknowledged the primary point of criticism of this trigger theory: "Pinpointing the moment of injury retrospectively is sometimes difficult, but we cannot exalt ease of proof or administrative convenience over faithfulness to the policy language; our confined task is to review the contract, not to revise it."¹¹⁵ Perhaps because the actual injury or injury-in-fact trigger most closely tracks the policy language, it has gained traction as the proper trigger theory in determining coverage for progressive property damage claims.¹¹⁶

D. Continuous Trigger

A "continuous trigger," although sometimes applied differently by the courts, generally provides that bodily injury and property damage that are continuous in nature are covered by all policies in effect during the time the damage takes place. Neither the date of the negligent act nor the discovery of the damage is particularly relevant in applying a continuous trigger theory. Perhaps the most widely cited case supporting a continuous trigger theory—albeit not in the construction defect arena—is *Keene Corp. v. Insurance Company of North America*.¹¹⁷ The continuous trigger is often applied in construction defect cases.¹¹⁸

The CGL policy form was revised in 2001 in response to the tendency of courts to apply a continuous or multiple trigger. The 2001 revision requires that bodily injury or property damage was not known to the insured prior to the inception of the policy period. That provision, known as the "Montrose" provision, is located in the insuring agreement, and states as follows:

Prior to the policy period, no insured listed under Paragraph 1. of Section II—Who is An Insured and no 'employee' authorized by you to give or receive notice of an 'occurrence' or claim, knew that the 'bodily injury' or 'property damage' had occurred, in whole or in part. If such a listed insured or authorized 'employee' knew, prior to the policy period, that the 'bodily injury' or 'property damage' occurred, then any continuation, change or resumption of such 'bodily injury' or 'property damage' during or after the policy period will be deemed to have been known prior to the policy period.

The provision sets out criteria for the means whereby bodily injury or property damage is deemed to have been known by the insured to have occurred, including the

earliest time when the insured reports the bodily injury or property damage, receives a written or verbal demand or claim for damages, or becomes aware by any other means that bodily injury or property damage has occurred. The provision is an attempt to isolate a loss in a single policy once it becomes known. Obviously, the application of a continuous trigger and allocation among triggered policies is a source of much negotiation during mediation and settlement.

VII. ALLOCATION AMONG MULTIPLE POLICIES

When multiple policies are triggered by a single occurrence, another facet of the occurrence trigger issue is the allocation of the loss over those multiple policies. This issue has spawned nearly as much litigation as the trigger issue and will be briefly summarized here. The two basic methods of allocation are joint and several (all sums) and pro rata. Of course, there are numerous hybrid and varied allocations, many of which enter into settlement of claims in mediation.

A. All Sums (Joint and Several) Allocation

The joint and several approach originated in *Keene Corp. v. Insurance Co. of North America*.¹¹⁹ In that case, the court held that if a policy is triggered, the insurer is required to defend and indemnify the insured to the extent of the entire policy limits, even though part of the injury may have occurred when the policyholder was self-insured. In other words, there is no proration between policy periods. This approach is applied in a minority of jurisdictions.

The joint and several allocation method is also referred to as “all sums” allocation. It was applied in *Armstrong World Indus., Inc. v. Aetna Cas. & Sur. Co.*,¹²⁰ in which Armstrong sued one of its insurers for the costs of asbestos abatement and asbestos related bodily injuries. The court held that where an insured holds a policy obligating the insurer to pay for all damages for which the insured becomes liable, the insured may select a single policy that most fully indemnifies it, subject to any deductible. *Armstrong* allows insureds with multiple insurers during a long tail exposure to select the most favorable policy—in terms of the highest limits or the lowest deductible—for indemnification. The selected insurer has a right to contribution from other insurers participating in the loss but that were not selected.

Joint and several allocation often goes hand-in-hand with application of a multiple trigger. One of the seminal construction coverage cases to apply that trigger, and joint and several allocation, is *Gruol Constr. Co. v. Insurance*

Co. of N. Am.,¹²¹ a case in which the insured contractor performed defective backfilling that caused gradual dry rot over a number of years. The court held that all three insurance policies in effect during the five-year period were triggered. Therefore, the court found each insurer jointly and severally liable for the property damage. It held that in a dispute between an insured that has sustained damages of a continuing nature and the insurers providing coverage, the burden of apportionment is on the insurers. Thus, once the insured shows that policies are triggered, the insurers must apportion the damages, removing that burden from the insured.

Texas courts apply the joint and several approach to construction cases. In *Lennar Corp. v. Markel Am. Ins. Co.*,¹²² after applying the actual trigger, the Supreme Court of Texas, relying on *Am. Physicians Ins. Exchange v. Garcia*,¹²³ specifically refused to follow the pro-rata approach and clarified that Texas has adopted joint and several allocation in the context of CGL coverage for the installation of defective EIFS in hundreds of homes. The court allowed the insured to select the policy to respond to the loss, sometimes referred to as a “targeted tender,” allowing the targeted insurer to seek subrogation (or contribution) from other insurers whose policies were triggered by the claim.¹²⁴

In *State v. Continental Ins. Co.*,¹²⁵ the California Supreme Court applied an “all-sums-with-stacking” rule. In light of their “all sums” language, the court held that the policies obligated the insurers to pay all sums for property damage attributable to the Stringfellow hazardous waste site, up to their policy limits, if applicable, as long as some of the continuous property damage occurred while each policy was on the loss. The court also allowed stacking of policy limits across multiple policy periods on a particular risk, forming an “über-policy” with a coverage limit equal to the sum of all insurance policies. However, the court noted that policies can be written to apply a different allocation rule, stating that in the future, contracting parties could write into their policies whatever language they agreed upon, including limitations on indemnity, equitable pro rata coverage allocation rules, and prohibitions on stacking.

Some insurers have heeded the California Supreme Court’s advice to modify their policies’ allocation approaches. A recent case to uphold such a limitation is *Colony Ins. Co. v. First Mercury Ins. Co.*,¹²⁶ applying Texas law, in which a roof leaked over the periods of several consecutive CGL policies. Settling a judgment against the insured, Colony, the second insurer in time, sought recovery from First Mercury, the first insurer

in time that issued two policies. Colony relied on the all-sums approach, arguing that First Mercury was obligated to pay the entire settlement because some of the property damage occurred during its policy period, and extended beyond it. However, First Mercury deleted the “continuation, change, or resumption” language from the standard occurrence provision of its policy, thereby limiting its exposure to damage that only occurred during its policy period, and eliminating an obligation to cover property damage beyond its policy period. Therefore, the court held that First Mercury was obligated to cover only the property damage that occurred during its two policies, and not all of the property damage occurring beyond its policies and within the Colony policy periods. The court ruled that Colony was unable to prove, at a bench trial, that First Mercury paid less in settlement than it owed under its two policies.

B. Pro Rata Allocation

The pro rata allocation method refers to various methods used by courts to allocate loss among multiple policies triggered by continuous injury. Unlike the joint and several allocation method, each policy is liable only for a portion of the loss, rather than bearing responsibility for all damages. In addition, under a pro rata allocation, the insured may be responsible for uninsured periods and deductibles. This is the majority approach of state courts that have considered the allocation issue.

The seminal case as to pro rata allocation is *Insurance Co. of N. Am. v. Forty-Eight Insulations, Inc.*¹²⁷ In the context of applying the exposure trigger to asbestos injuries, the court allocated defense and indemnity costs for each underlying claim based on the years a worker inhaled asbestos fibers.

In the construction defect context, another such case is Minnesota’s *Wooddale Builders, Inc. v. Maryland Cas. Co.*¹²⁸ In that case, the court allocated damages among eight CGL policies for property damage arising out of long-term infestation of mold in homes constructed by the insured. In applying a pro rata allocation, the court considered each insurer’s time on the risk, the period over which liability is allocated, the total damages to be allocated, and if applicable, any damages to the insured for self-insured periods. In other words, the court applied the pro rata by time on the risk method.

In *Public Serv. Co. v. Wallis & Cos.*,¹²⁹ the Colorado Supreme Court expressly rejected all sums in favor of the pro rata approach. The court found that, in cases of continuous, progressive, and indivisible environmental damage, where it would be unreasonable to expect juries

to allocate actual damages to specific policy periods, liability should be allocated proportionally among insurance policies according to time on the risk. Under the pro-rata time on risk approach, the total amount of damages is divided by the total number of years to yield the amount of damage attributable to each year. In a subsequent construction defect case, *Hoang v. Assurance Co. of America*,¹³⁰ the Colorado Supreme Court relied on *Wallis*, holding that, where property damage occurs gradually over time, the trial court may make a reasonable estimate of the portion of the damage attributable to each year and allocate liability to each policy triggered by the damage.

An Iowa court in *Pella Corp. v. Liberty Mut. Ins. Co.*¹³¹ applied the pro rata allocation method where Pella, the insured window manufacturer, sought reimbursement from Liberty Mutual, its insurer, for its defense costs in multiple underlying suits for water damage caused by its windows. Liberty issued Pella eight successive CGL policies. As to the use of the term “those sums” in the insuring agreement, the court stated there was an inherent awkwardness in advocating “all sums” allocation when the insurance policies before the court do not include those words. However, the court noted that a difference between “those sums” and “all sums” wording should not matter, even though the word “those” might imply a greater degree of particularity than the word “all.” Upon review of applicable authorities, the court concluded that the distinction did not suffice to favor Liberty Mutual’s advocacy for pro rata allocation. On the other hand, after surveying the case law, the policy requirement that the damage must take place “during the policy period” was clear and weighed heavily in favor of an interpretation of the CGL policies for pro rata allocation. Finally, the court rejected Pella’s reliance on “noncumulation” (or anti-stacking) provisions in the policies, finding that, while those provisions sought to effectively apply a single occurrence limit to all triggered policies for damages that are caused by a single occurrence, they did not explicitly impose all sums allocation.

Noncumulation clauses, sometimes referred to as “anti-stacking provisions,” are a reaction by the insurance industry to the application of multiple triggers to tap successive years of coverage for long-term bodily injury or property damage claims. A typical noncumulation clause provides as follows:

It is agreed that if a loss covered under this policy is covered in whole or in part under any other policy issued to the insured prior to the effective date of this policy, the limits of liability as stat-

ed in the declarations shall be reduced by any amounts due to the Insured under such prior insurance.

Analysis of the effect of noncumulation clauses upon coverage under multiple policies is beyond the scope of this paper.¹³²

In *Crossman Communities of N.C., Inc. v. Harleysville Mut. Ins. Co.*,¹³³ the South Carolina Supreme Court clarified South Carolina law and adopted the pro rata approach for allocation in the construction defect context. In that case, the insured developer sought coverage under its CGL policy for damages arising out of a lawsuit by condominium unit owners over defective construction. The court held that damage caused to condominium units from repeated water intrusion constituted an occurrence under the developer's CGL policy but rejected the insured's reliance on the joint and several allocation approach. It adopted the time on the risk approach, stating the approach best conformed to the terms of a standard CGL policy and to the parties' objectively reasonable expectations. In particular, the time-on-risk approach requires the insured to bear a pro rata portion of the loss corresponding to any portion of the progressive damage, during which the insured was not insured or purchased insufficient insurance.

Nevertheless, the court held that a strict application of the basic time on risk formula (*i.e.*, the formula consisting of a numerator representing the number of years an insurer provided coverage and denominator representing the total number of years during which the damage progressed) might not always be appropriate. There were numerous buildings involved in the underlying lawsuit, each with its own certificate of occupancy, and the parties stipulated that the damage began within 30 days after the certificate of occupancy was issued for each building. Further, they stipulated that the damage progressed until repaired or until the insured paid to settle the underlying cases, whichever came first.

As to each building, the court determined that each policy was on the risk for a slightly different proportion of the total damage. However, the court left it to the discretion of the trial court to determine whether it was necessary to apply the time on the risk formula separately for each individual building or whether it would be prudent to modify the default formula to determine a reasonable methodology for this case.

This guidance from the South Carolina Supreme Court is another example of how malleable the allocation of damages among multiple insurance policies can be. This leaves a playing field in which parties can maneuver to

reach a settlement as to complex allocation issues relating to complex construction defect claims, particularly in the context of mediation. Often, the ingenuity of the parties can lead to a beneficial settlement within the parameters of the various allocation theories and the particular claim.

Another such example is *Penn. Nat'l Mut. Cas. Ins. Co. v. Zonko Bldrs, Inc.*,¹³⁴ where the insured negligently constructed a series of houses over a period of years. After judgment, the contractor assigned its rights against its insurer to the owner. The insurer argued that it was entitled to summary judgment because the owner could not identify any damage that occurred during its policies or establish the amount of property damage that occurred during them. The Delaware court rejected this argument, concluding that pro rata allocation among policy years does not operate as an exclusion to insurance coverage, remanding the case to determine if subcontractors performed work during the relevant policy years.¹³⁵

VIII. THE "PROPERTY DAMAGE" REQUIREMENT

The concept of "property damage" is central to CGL insurance coverage for construction risks. As construction lawyers are aware, problems in a construction project do not result only in damage to the project or the property of third parties, but also in economic losses that go beyond the value of damaged property itself. As discussed below, it is with respect to economic losses that disputes regarding the definition of "property damage" most often occur. The standard CGL policy defines "property damage," in relevant part, as:

- a) Physical injury to tangible property, including all resulting loss of use of that property. All such loss of use shall be deemed to occur at the time of the physical injury that caused it; or
- b) Loss of use of tangible property that is not physically injured. All such loss of use shall be deemed to occur at the time of the 'occurrence' that caused it.

A. Physical Injury to Tangible Property and Loss of Use of Tangible Property

In 1973, the insurance industry revised the definition of "property damage" to require "physical injury to or destruction of tangible property." It was thought that the addition of the word "physical" (together with other exclusions in the policy) would eliminate coverage for claims for damages such as diminution in value of property that was not itself physically injured. The "physical

injury” requirement was a reaction to the landmark case of *Hauenstein v. St. Paul-Mercury Indemnity Co.*¹³⁶ In that case, the insured supplied defective plaster applied to the walls and ceilings of a building. The plaster shrank and cracked after application and had to be removed and replaced. The court held that the application of the defective plaster lowered the market value of the building, constituting property damage under the terms of the policy’s insuring agreement.¹³⁷ The court further held that the measure of the damage was the diminution in the market value of the building or the cost of removing the defective plaster and restoring the building to its former condition, plus any loss from deprivation of use, whichever was lesser. By adding the “physical” injury” requirement to the definition of property damage, the insurance industry hoped that this type of diminution in value claim would be eliminated from CGL coverage.

The first prong of the “property damage” definition is the one most frequently at issue in the construction context, particularly with respect to construction defect claims. The key is distinguishing between a mere defect and “physical injury to tangible property.” Generally speaking, tangible property suffers a physical injury when the property is altered in appearance, shape, color, or another material dimension.¹³⁸

The most recent foray into this issue under Texas law is *TIG Ins. Co. v. Woodsboro Farmers Coop.*,¹³⁹ in which the Fifth Circuit closely adhered to the rationale of *Lamar Homes*. Woodsboro, the owner of two defectively constructed silos, recovered a million-dollar arbitration award against the contractor due to the defects. TIG, the insurer, denied indemnity, and the district court accepted the argument that the damages constituted the cost of repairing silos that were defective in their entirety. The Fifth Circuit reversed, holding that tangible property suffers a physical injury when the property is altered in appearance, shape, color, or another material dimension.¹⁴⁰ Further, the court took issue with TIG’s argument there was no covered property damage because the damaged property was the silos themselves, and not “other” property. The court held that under *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*,¹⁴¹ the issue of resulting damage is irrelevant, and the existence of covered property damage is decided by the policy exclusions. Evidence indicated that the defects in the silo roofs left them unsecured and free to move around so that the roof superstructure was moving and shifting in the wind and weather, causing the metal parts of the roofs to fatigue, and then bend, ultimately damaging the roof. Similar degradation to the rest of the structure was noted. The Fifth Circuit concluded that the costs to repair the defects to render the silos watertight constituted property damage.¹⁴²

Similarly, in *Mid-Continent Cas. Co. v. Vibrant Builders, LLC*,¹⁴³ the court upheld the existence of property damage. The insured contractor contracted to supervise, direct, manage, construct, and assist in the construction, sale, marketing and repair of a condominium project. The homeowners association sued the insured alleging that it was negligent in the construction, design and installation of the condominiums. Mid-Continent denied defense and indemnity, despite numerous allegations of damage to materials, building components, insulation and interior finishes such as drywall, baseboards and flooring, attributable to defective roofing, skylights, gutters and scuppers, stucco, as well as other defects. Therefore, the court held that there was physical injury to tangible property amounting to property damage alleged against the insured.¹⁴⁴

The Florida Supreme Court undertook a detailed analysis of the property damage issue from a slightly different perspective in *Auto-Owners Insurance Co. v. Pozzi Window Co.*¹⁴⁵ There, the court grappled with the distinction between replacement of a building component rendered defective by faulty installation as opposed to a component that was inherently defective and installed properly. The owner purchased windows, which were installed by a subcontractor. Subsequent to their installation, the windows leaked, causing damage to substantial portions of the owner’s home as well as the windows, which had to be removed and replaced. The CGL insurer agreed that the damages to the home were covered but denied coverage for the replacement of the windows themselves. The court concluded that the record did not resolve whether the windows themselves were defective at installation, or whether they eventually leaked because of defective installation. According to the court, if the windows themselves were defective, then the cost of their replacement would not be the result of property damage but simply the cost of rectifying defective work itself. In contrast, if the claim was for the replacement of windows that were not defective at installation, but instead were damaged by defective installation, then that would constitute damages because of property damage and the replacement of the windows would be covered.

B. The Incorporation Cases

Competing views exist as to whether the mere incorporation of a defective component into a larger product constitutes property damage. When a product manufactured or installed by an insured has been integrated into another party’s property, damage to that property, as a whole, excluding the cost of repairing or replacing the defective part, constitutes property damage.¹⁴⁶

One of the most comprehensive discussions of this issue under Texas law is *U.S. Metals, Inc. v. Liberty Mut. Group, Inc.*¹⁴⁷ In that case, ExxonMobil filed suit against U.S. Metals, alleging that U.S. Metals provided defective weld neck flanges for installation in ExxonMobil refineries. These flanges were welded and bolted into insulated pipes at the refineries. While testing the systems before putting them into operation, ExxonMobil discovered a leak in one of the flanges, and alleged that none of flanges met industry standards, as required by the contract with U.S. Metals, and that it was required to order new flanges from a different manufacturer and remove and replace all defective flanges to avoid the risk of fire and explosion. Replacement of the flanges involved stripping the temperature coating and insulation (which were destroyed in the process), cutting the flange out of the pipe, removing the gaskets (which also were destroyed in the process), grinding the pipe surfaces smooth for rewelding, replacing the flange and gaskets, welding the new flange to the pipes, and replacing the temperature coating and insulation. The replacement process required portions of the refineries to be shut down for several weeks. ExxonMobil sued U.S. Metals for the cost of replacing the flanges and \$16.6 million for the lost use of the diesel units. U.S. Metals then settled with ExxonMobil and claimed indemnification from its CGL insurer.

The court faced the incorporation theory as an issue of first impression—is property physically injured simply by the incorporation of a faulty component with no tangible manifestation of injury? The court ultimately held that, since a defective product that causes damage is not an occurrence until the damage actually happens, “it would be inconsistent to now find that a defective product that does *not* cause damage is nevertheless an occurrence at the time of incorporation,”¹⁴⁸ rejecting the incorporation theory. As to the cost of removing the defective flanges (rip and tear damages), however, the court noted that the diesel units *were* physically injured in the process of replacing the defective flanges because the original welds, pipe coating, insulation, and gaskets were destroyed in the process of replacing the defective flanges. This issue is discussed more fully below in connection with the impaired property exclusion.

Despite the seeming breadth of the Illinois Supreme Court’s recent opinion in *Acuity v. M/I Homes of Chicago, LLC*,¹⁴⁹ the Seventh Circuit reminded insureds and insurers alike that the CGL coverage applies only to physical injury to tangible property, *i.e.*, property damage. In *St. Paul Guardian Ins. Co. v. Walsh Constr. Co.*,¹⁵⁰ Walsh was the general contractor for a portion of O’Hare International

Airport. Walsh retained a subcontractor to manufacture the steel and curtain wall, which contained defective steel columns. Those defects led the city of Chicago to question the structural integrity of the canopy system. The City and Walsh entered a settlement where Walsh agreed to repair the columns at its own expense. Walsh then turned to its insurer for coverage. The Seventh Circuit agreed with the insurer that there was no coverage because there was no damage to anything other than the work Walsh performed. The court rejected Walsh’s argument that this “creates a perverse outcome because it penalizes the company for taking steps to prevent the canopy’s catastrophic collapse” because there were “many reasons (economic and otherwise) why a party in Walsh’s shoes would take steps to prevent such a calamitous failure.”¹⁵¹ It also rejected Walsh’s argument that the steel columns were so intertwined with the canopy system that damage to them necessarily included damage to the canopy as a whole because, unlike the cases cited by Walsh, the entire canopy did not need to be taken down and rebuilt, but “the outcome may be different if physical abnormalities in the columns required Walsh to disassemble the canopy and start anew.”¹⁵² The second prong of the “property damage” definition deals with inability to use property that is not physically injured. An example is where a property owner alleges his business sustained economic loss during a construction delay.¹⁵³ Other examples exist when, for example, a component part causes a loss of use to the product into which it was incorporated.¹⁵⁴ Similarly, the second prong may be satisfied if a piece of equipment fails and that causes a loss of use beyond the piece of equipment itself.¹⁵⁵ For a discussion of these cases, as well as a historical perspective of the property damage definition, see James Duffy O’Connor, *Construction Defects: “Property Damage” and the Commercial General Liability Policy*, 24 CONSTR. LAW. 30 (Spring 2004). Outside of this context, however, the second prong of the “property damage” definition oftentimes is problematic because of the impaired property exclusion elsewhere in the policy (as discussed below).

C. The Third-Party Property Damage Issue

It has been argued that defective construction claims fail to allege property damage because damage to the work itself constitutes a mere economic loss or an uninsurable business risk. The definition of “property damage” does not require that the “physical injury to tangible property” be to the property of others or of third parties. In rejecting the view that the “property damage” definition requires damage to third party property, the District of Kansas, in *Fid. & Deposit Co. v. Hartford Cas. Ins. Co.*,¹⁵⁶ stated:

The definition of property damage in the policies does not limit the coverage to property that is not in the possession of or work product of the insured. [The insured] correctly points out that if the work product of the insured could never come within the definition of property damage, then the exclusions set forth in the policy to limit such damages would be without meaning.¹⁵⁷

Nevertheless, some courts have read the property damage requirement in conjunction with the business risk exclusions to hold that damage to the work itself does not constitute property damage.¹⁵⁸

IX. PROPERTY DAMAGE EXCLUSIONS

The standard CGL coverage forms as to “bodily injury” and “property damage” are subject to approximately 20 exclusions. The exclusions of particular applicability in the construction context are discussed below.

A. Expected Or Intended Injury Exclusion

As the discussion of the definition of “occurrence” emphasized, the notion of *fortuity*—that is, an accident—is central to the principle of liability insurance that an insured cannot control the risk or intentionally cause “bodily injury” or “property damage”. Exclusion (a), the Expected Or Intended Injury Exclusion, states that the insurance does not apply to “bodily injury or property damage expected or intended from the standpoint of the insured.” The Expected Or Intended Injury Exclusion had its genesis in prior definitions of “occurrence,” and is discussed above in connection with the definition of “occurrence.” A recent example of court interpretation of the exclusion is *Barrs v. Auto-Owners Ins. Co.*¹⁵⁹ In *Barrs*, the insured owner, after settlement with the insured contractor, sought coverage from the contractor’s insurer as to failure to complete a renovation project, and lost materials, claiming that the insured’s negligence allowed the theft of the materials and delayed the project. The owner alleged negligent hiring, retention and supervision of the responsible subcontractor by the insured contractor. The court held that viewed from the standpoint of the insured, the allegations involved an occurrence, *i.e.*, an accident, or an unexpected happening, rather than one occurring through intention to design.¹⁶⁰ For much the same reason, the court declined to apply exclusion (a), the Expected Or Intended Injury Exclusion, holding

that the negligent hiring and retention claims arose out of unintentional conduct.

B. Contractual Liability Exclusion (and Coverage)

Exclusion (b), the Contractual Liability Exclusion, is of potential application in the construction context because construction contracts usually contain some form of indemnity or hold harmless agreement whereby a downstream party such as a contractor agrees to indemnify the upstream party, such as an owner, for bodily injury and property damage arising out of the contractor’s operations. An example of such an indemnity agreement is found in paragraph 3.18 of A201, the General Conditions for the Construction Contract promulgated by the American Institute of Architects. The enforceability of an indemnity clause in a construction contract is determined by reference to the applicable state law and may be subject to regulations or an anti-indemnity statute. That indemnity obligation may be insured under a CGL policy, but under an equally complex exclusion. The standard CGL policy may provide coverage for this indemnity exposure by means of the exception to the Contractual Liability Exclusion. The exclusion states that the insurance does not apply to:

“Bodily injury” or “property damage” for which the insured is obligated to pay damages by reason of the assumption of liability in a contract or agreement. This exclusion does not apply to liability for damages:

- (1) That the insured would have in the absence of the contract or agreement; or
- (2) Assumed in a contract or agreement that is an “insured contract,” provided the “bodily injury” or “property damage” occurs subsequent to the execution of the contract or agreement.

In turn, the defined term “insured contract” lists the types of indemnification clauses to which the exclusion does not apply (and for which there may be coverage), including a lease of premises, a sidetrack agreement, an easement or license agreement, an obligation to indemnify a municipality except in connection with work for a municipality, and an elevator or maintenance agreement. Most significantly, subparagraph (f) of the definition of “insured contract” includes:

That part of any other contract or agreement pertaining to your business (including an indemnification of a municipality in connection with work performed for a municipality) under which you assume the tort liability of another party to pay for “bodily injury” or “property damage” to a third person or organization. Tort liability means a liability that would be imposed by law in the absence of any contract or agreement.

As noted above, the general purpose of the exception to exclusion (b) is to insure the indemnitor’s obligation to indemnify the indemnitee for bodily injury or property damage to third parties arising out of performance of the contract. While exclusion (b) excludes coverage for all liability assumed by contract, the exception for insured contracts for the most part swallows the exclusion for many claims in the construction context.

It must be emphasized that the exclusion does not apply to property damage for which the insured is directly liable based on breach of contract. By its terms, it applies only to liability “by reason of the assumption of liability”—that is, pursuant to a hold harmless agreement that is not within the companion definition of “insured contract.” Case law upholds this underwriting intent. In *American Family Mutual Insurance Co. v. American Girl, Inc.*,¹⁶¹ the court held that the exclusion applies where the insured has contractually assumed the liability of a third party, as in an indemnification or hold harmless agreement, and that it does not operate to exclude coverage for any and all liabilities to which the insured is exposed under the terms of the contracts it makes generally.¹⁶²

A minority of cases take the opposite view, that any breach of a direct contractual obligation triggers the contractual liability exclusion. But these cases often embrace the proposition with little analysis.¹⁶³

A number of the minority jurisdictions have embraced a more elaborate analysis, including the Texas Supreme Court in *Gilbert Tex. Constr., L.P. v. Underwriters at Lloyd’s London*.¹⁶⁴ In that case, the court held the exclusion applies even if the insured does not assume the liability of another and is sued only for its own breach of contract, despite the well-accepted intent behind exclusion to limit it to liability assumed under indemnity clauses.¹⁶⁵

Highly simplified, Gilbert, the insured contractor, faced a breach of contract claim brought by DART, the owner, based upon Gilbert’s failure to comply with a contractual provision that obligated Gilbert to protect and to repair any damage to all existing improvements and

utilities, and on adjacent property of a third party, arising out of construction of a light rail system. Under Texas cases decided only three years earlier, the claim against Gilbert had all the earmarks of a covered claim—it involved an “occurrence” of unexpected and unintended “property damage” to a third party’s property, as established in *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*¹⁶⁶ While the court acknowledged the long-standing definition of “insured contract” as to assumption of the liability of another, it went on to determine that the clause before it in which Gilbert assumed an additional duty not only to DART, the owner, but also to neighboring landowners, brought it within the terms of exclusion (b).¹⁶⁷

The court introduced a new concept to exclusion (b) and risk management. It determined that the obligation to repair or pay for damage to third party property resulting from the failure to comply with the requirements of the contract extended beyond the obligations that Gilbert would have under “general law” and incorporated contractual standards to which Gilbert obligated itself. The court held that when an insured affirmatively agrees to be liable for damages in excess of what it would have been liable for in tort or in contract under “general law” principles, the liability is assumed and excluded by the contractual liability exclusion.¹⁶⁸ Understood as such, the court’s opinion does not amount to an across-the-board holding that any contractual undertaking constitutes liability assumed under a contract for purposes of exclusion (b).

The complexity created by Gilbert created much consternation in the construction and insurance industries and eventually led to an even more complex decision in *Ewing Constr. Co., Inc. v. Amerisure Ins. Co.*¹⁶⁹ Procedurally, the case involved an initial opinion from the Fifth Circuit,¹⁷⁰ and withdrawal of that opinion and certification to the Texas Supreme Court.¹⁷¹ The Texas Supreme Court accepted the certified questions, ultimately disagreeing with the Fifth Circuit’s reasoning in its withdrawn opinion. In addressing the questions before it, it was necessary for the court to also address its prior opinion in *Gilbert*. In that regard, the court stated that, in *Gilbert*, it determined that “assumption of liability” means that the insured has assumed a liability for damages that exceeds the liability it would have under general law. Otherwise, the words “assumption of liability” would be meaningless and surplusage.¹⁷²

In *Ewing*, the insured contractor was sued for breach of the implied warranty of performance in a good and workmanlike manner in the construction of defective tennis courts. The primary question before the Texas

Supreme Court was whether the contractual liability exclusion applied to property damage arising out of defective work performed under a contract in which a general contractor agrees to perform its construction work in a good and workmanlike manner, without any more specific provisions. The court determined that the allegations of the owner, a school district, that Ewing failed to perform in a good and workmanlike manner were substantively the same as its claims that Ewing negligently performed under the contract because they contained the same factual allegations and alleged the same misconduct. The court concluded that a contractor who agrees to perform its construction work in a good and workmanlike manner, without more, does not enlarge its duty to exercise ordinary care and thus does not “assume liability” for damages in excess of “general law” arising out of its defective work that would trigger the contractual liability exclusion.¹⁷³

Crownover v. Mid-Continent Cas. Co.,¹⁷⁴ was a companion case to *Ewing* in the Fifth Circuit, and oral arguments were heard at the same time. The *Crownover* case was stayed pending the result in *Ewing*, and it was expected that a similar result would be reached—that the contractual liability exclusion did not apply to a breach of a construction contract provision, this time involving an express warranty to repair defects. The Fifth Circuit agreed, adopting the same analysis of the Texas Supreme Court in *Ewing*.

A more recent opinion applying Texas law on this issue is *Siplast, Inc. v. Employers Mut. Cas. Co.*,¹⁷⁵ in which the insured roofing manufacturer sought coverage for alleged defective installation of a roof membrane on a high school building. Although the plaintiff in the underlying lawsuit alleged the contractor violated an express term of its construction contract, which caused damage to the plaintiff’s property, the allegation did not open the contractor “up to additional liability beyond that found at law.”

C. Owned Property and Alienated Premises Exclusions

The CGL policy is a liability policy and is intended to cover just that: liability to third parties. As such, the policy excludes damage to property owned by the insured on the premise that first party property insurance is the appropriate vehicle to cover such losses. Subparagraph (1) of exclusion (j), states that the insurance does not apply to property damage to:

Property you own, rent, or occupy, including any costs or expenses incurred by you, or any other person, organization or entity, for repair,

replacement, enhancement, restoration or maintenance of such property for any reason, including prevention of injury to a person or damage to another’s property.

This exclusion generally protects against the “moral hazard” problem, in that theoretically an insured has less incentive to take precautions to prevent damage to its own property if it has insurance to cover that damage. The exclusion is intended to prevent the liability insurer from becoming a guarantor of the insured’s operations.¹⁷⁶ While case law addressing the owned property exclusion is not extensive, it generally upholds this intent as to construction exposures. In *Cam-Sam Real Estate Holding, LLC v. Merchants Mut. Ins. Co.*,¹⁷⁷ the court reiterated that the owned or leased premises exclusion insulates against the moral hazard problem where an insured has less incentive to take precautions owing to the existence of insurance.

The applicability of the owned property exclusion can arise in the context of condominium developments. For example, in the event the developer of the project is unable to sell the units at the pace it intended, it frequently remains the owner of the unsold units. This was the situation in *State Farm Fire & Casualty Co. v. English Cove Ass’n, Inc.*¹⁷⁸

The homeowners association filed suit against the developer for construction defects in the common areas, including the exterior walls in which water intrusion took place. The insurer raised the owned property exclusion as to 43 of the 160 units of which the developer retained ownership. The court held that since the developer retained ownership of the unsold units and had an undivided interest in the common areas of the project, and since the word “owned” was not ambiguous, the policy exclusion applied.¹⁷⁹

Subparagraph (2) of exclusion (j) is a companion exclusion to exclusion (j)(1) and excludes coverage for property damage to:

Premises you sell, give away or abandon, if the “property damage” arises out of any part of those premises. However, this exclusion is subject to the following exception: Paragraph 2 of this exclusion does not apply to the premises are “your work” and were never occupied, rented or held for rental by you.

The prior version of this exclusion was referred to as the alienated premises exclusion because it applied to “premises alienated by the named insured and arising

out of the premises.” That earlier edition did not include the exception for premises that are “your work”—that is, the named insured’s work—that were never occupied, rented, or held for rental by the named insured. As such, the current version of the exclusion, added in 1986, does not apply to developers and contractors who ultimately sell the construction project. The prior absence of this exception caused the exclusion to be applied by some insurers to a contractor’s completed operation despite the subcontractor exception to the “your work” exclusion.¹⁸⁰ On the other hand, the court in *Maryland Casualty Co. v. Reeder*¹⁸¹ viewed this scenario as unfair. In that case, a developer had conveyed his interest in a project years before any of its CGL policies were issued to him and before construction of the defective condominiums involved in the claim commenced. The court determined that application of the alienated premises exclusion under those circumstances would rob the developer of any benefit whatsoever from the insurance under his CGL policy.

These types of arguments led to clarification in 1986 that the exclusion does not apply to a contractor’s work that was never occupied, rented, or held for rental by it. The application of the alienated premises exclusion should now be limited primarily to situations involving the sale of premises that were not constructed or developed by the insured for sale. However, where a contractor or developer will occupy or rent a completed project prior to selling it, it may seek a modification of the exclusion to add a time limitation in the event it is possible to predict under what circumstances, and for how long, the insured may occupy, rent, or hold for rent the premises before selling them and running afoul of the exclusion.

D. Care, Custody, or Control Exclusion

Subparagraph (4) of exclusion (j) provides that the insurance does not apply to “personal property in the care, custody or control of the insured.” An exception to the exclusion states that it does not apply to liability assumed under a sidetrack agreement.

In 1986, the exclusion was modified to make it clear that it applies only to *personal* property in the care, custody, or control of the insured. Earlier versions of exclusion (j)(4) stated that the insurance did not apply to property damage to property in the care, custody, or control of the insured or as to which the insured was for any purpose exercising physical control. This was problematic because under the standard 1973 version, some courts applied the exclusion to the construction project—that is, real property—where the insured was in charge of the entire jobsite. For example, in *Estrin*

Construction Company, Inc. v. Aetna Casualty & Surety Co.,¹⁸² a windstorm toppled the partially completed walls of a warehouse project. Although the court recognized the principle that real property is not usually found to be in the care, custody, or control of the contractor engaged to work on less than an entire structure, the court held that because the insured under the terms of its contract had immediate supervision of every phase of the project, the real property was in the care, custody, or control of the contractor for purposes of the exclusion.¹⁸³ Whether certain property constitutes real property is frequently disputed. One factor to consider is whether the damaged property was affixed to the realty, as illustrated in the Texas case, *Houston Building Services, Inc. v. American General Fire & Casualty Co.*¹⁸⁴

Another matter worth assessing is *Barrs v. Auto-Owners Ins. Co.*,¹⁸⁵ in which the owner, after settlement with the insured contractor, sought coverage from the contractor’s insurer for failure to complete a renovation project, and for lost materials, claiming that the insured’s negligence allowed the theft and delayed the project. The owner alleged negligent hiring, retention and supervision of the responsible subcontractor by the insured contractor. After determining that the owner had alleged an occurrence, the court declined to apply exclusion (j) (4), the care, custody or control exclusion, because the employee that stole the materials was acting outside the scope of his employment.¹⁸⁶ In addition, the court held that exclusion (m), the impaired property or property that has not been physically injured exclusion, was inapplicable because the owners claim did not arise out of a breach of contract, but rather out of negligence in allowing the employee to steal materials.¹⁸⁷ Finally, the court held that because the insurer refused to defend its insured without any reservation of rights, the insurer was obligated to pay the entire judgment even though the settlement agreement did not allocate between “covered and non-covered claims.”¹⁸⁸ Note that allocation between covered and non-covered claims that are settled is frequently an issue.¹⁸⁹

E. Ongoing Operations and Incorrect Work Exclusions

As noted above, the primary means of insuring a project during construction is builders risk insurance, which is first party coverage usually obtained by the owner or the general contractor. However, in certain circumstances, the CGL policy also provides coverage for operations in progress, and the operations exclusions have been frequently litigated in the construction defect context. The operations exclusions mirror builders risk coverage in that they usually exclude the cost of making

good faulty workmanship but provide coverage for ensuing loss where defective workmanship results in another cause of loss to other work. Under subparagraphs (5) and (6) of exclusion (j), the concept of “ensuing loss” is embodied in the limitation of the exclusions to “that particular part” upon which the insured is performing operations, or “that particular part” of property that must be replaced because of defective work performed upon it, preserving coverage for other work.

Subparagraph (5) of exclusion (j), commonly referred to as the ongoing operations exclusion, states that the insurance does not apply to property damage to:

That particular part of real property on which you or any contractors or subcontractors working directly or indirectly on your behalf are performing operations, if the “property damage” arises out of those operations.

In the seminal Texas case, *CU Lloyd's of Texas v. Main Street Homes, Inc.*,¹⁹⁰ the court observed that because of the use of the present tense, courts have found that the ongoing operations exclusion does not apply to property damage that occurs after construction is complete, but only to property damage that occurs while operations are in progress.¹⁹¹ In addition, courts have found the exclusion applies only to damage caused during *active* physical construction activities, as explained in *Mid-Continent Casualty Co. v. JHP Development, Inc.*¹⁹² There, the court held that exclusion (j)(5) did not apply to damage caused during a prolonged suspension of active construction work during which the insured was not actively performing any task at the jobsite.¹⁹³

Assuming the property damage occurs while operations are in progress, the “that particular part” language further limits the scope of the exclusion. Only that particular part of the work on which operations are actually being performed and is damaged is excluded. In an explanatory circular, ISO gave an example where a steel company is erecting steel beams furnished by the general contractor. Having erected four of the beams, the subcontractor is in the process of erecting a fifth steel beam when the beam falls, resulting in damage to all five beams. Only the damage to the fifth beam is excluded as “that particular part upon which it was performing operations.”¹⁹⁴

In turn, Subparagraph (6) of exclusion (j), sometimes referred to as the incorrect work exclusion, is a companion to exclusion (j)(5). It states that the insurance does not apply to property damage to:

That particular part of any property that must be restored, repaired, or replaced because “your work” was incorrectly performed on it.

Exclusion (j)(6) is subject to the following exception:

Paragraph (6) of this exclusion does not apply to “property damage” included in the “products-completed operations hazard.”

The exception provision, that exclusion (j)(6) does not apply to the products-completed operations hazard, is routinely upheld by the courts and clarifies that the exclusion does not apply to a completed operations loss (that is, a loss that occurs after the work is put to its intended use or all work under the insured’s contract is completed). Rather, it is exclusion (l), the “your work” exclusion (discussed below), which applies in such situations. The importance of the distinction between ongoing operations and the products-completed operations hazard is a critical distinction as to interpreting many property damage exclusions in the CGL policy, especially as to coverage for defective workmanship.

As is the case with the ongoing operations exclusion, the “that particular part” language in the exclusion often limits its scope. In many construction claims, the amount of available coverage turns on the interpretation of the “that particular part” language. Insurers may argue that coverage for all of the insured’s work is excluded. Thus, the insured must be able to segregate out the defective from the non-defective portions of the work in determining “that particular part” in order to limit the scope of the exclusion.

*Mid-Continent Casualty Co. v. JHP Development, Inc.*¹⁹⁵ is a frequently cited case applying Texas law that provides a clear example. It involved a typical construction defect scenario where property damage caused by defective work on a condominium project allowed water to infiltrate and damage otherwise non-defective portions of the work. In upholding coverage for the non-defective portions of the condominium project under the contractor’s policy, the court applied the “that particular part” limitation in exclusion (j)(6). The court held that the exclusion barred coverage only for property damage to parts of the property that constituted defective work by the insured, and that the exclusion did not bar coverage for damage to parts of the property that were not defective but were damaged as a result of defective work by the insured on other parts of the property.¹⁹⁶

The Fifth Circuit also addressed the “that particular part” limitation under Texas law in *Gore Design Completion, Ltd. v. Hartford Fire Insurance Co.*¹⁹⁷ There,

the insured defectively wired a component of an in-flight entertainment system in a commercial aircraft, resulting in physical damage to the aircraft's entire electrical system. The court observed that if exclusion (j)(6) were applied to the entire aircraft, rather than only the in-flight entertainment system, the "that particular part" limitation would be read out of the policy.¹⁹⁸

In *Mid-Continent Cas. Co. v. Vibrant Builders*,¹⁹⁹ the insured contractor contracted to supervise, direct, manage, construct, and assist in the construction, sale, marketing and repair of a condominium project. The homeowners association sued the insured alleging that it was negligent in the construction, design and installation of the condominiums, causing damage attributable to defective roofing, skylights, gutters and scuppers, stucco, as well as other defects. The court rejected Mid-Continent's reliance upon Exclusions (j)(5) and (j)(6), the ongoing operations and incorrect work exclusions, holding that exclusion (j)(5) applied only during actual operations, and that allegations of property damage to otherwise non-defective work prevented the application of Exclusion (j)(6).²⁰⁰ The court also rejected Mid-Continent's reliance on exclusion (l), the your work exclusion, because allegations of damage to interior finishes that had not been performed by the insured, as well as personal property, were outside the insured's work.²⁰¹ On cross motions for summary judgment, the court held that Mid-Continent owed a duty to defend its insured in the underlying construction defect suit.

In *Amerisure Mutual Insurance Co. v. McMillin Texas Homes*,²⁰² the court considered the applicability of exclusions (j)(5) and (j)(6) in the context of determining an insurer's duty to defend the insured developer/contractor in a claim involving water infiltration into residential units. The court refused to apply the exclusions, relying primarily on *Mid-Continent Casualty Co. v. JHP Development, Inc.*,²⁰³ holding that the pleadings could be read to allege damage to non-defective work other than the defective synthetic stucco.²⁰⁴ *Transportation Insurance Co. v. Piedmont Construction Group, LLC*,²⁰⁵ provides an additional example of the competing arguments of insureds and insurers as to the scope of the term "that particular part." In that case, during the course of a dormitory renovation, a plumbing subcontractor negligently ignited wood scrap, damaging the rest of the dormitory. The insurer argued that because the contractor's renovation contract involved the entire dormitory, coverage for the entire loss was excluded. The court rejected this argument, determining "that particular part" of the real property upon which the contractor's subcontractor was working applied only to the room in which the plumber

was working at the time the fire was started, rather than the entire building that was being renovated at the time of the fire.²⁰⁶

Consider a similar opinion, *Suez Treatment Sols., Inc. v. ACE Am. Ins. Co.*²⁰⁷ In that case, Suez, the insured, was hired to upgrade the facilities at a wastewater treatment plant by installing a granulated activated carbon adsorber unit (a "GAC unit") to reduce mercury emissions at the plant. After start-up, fires occurred. Insurers filed a declaratory judgment action as to the duty to defend Suez in a lawsuit filed by the owner, alleging a laundry list of exclusions. As to exclusion (j)(5), the ongoing operations exclusion, the court rejected the argument that it applied to the property damage to the entire plant on which Suez was performing ongoing operations. Rather, its operations were limited to the GAC unit and did not include other damaged equipment.²⁰⁸

Nevertheless, insurers may still ignore the "particular part" limitation and argue for the broad entire scope of the insured's work interpretation. For example, in *Southern-Owners Ins. Co. v. MAC Contractors, Inc.*,²⁰⁹ the court construed the "that particular part" limitation language in Exclusions j.(5) and j.(6). The parties offered competing interpretations. The insurer argued it should be construed broadly to define "that particular part" by reference to the scope of the insured's project. The insured argued it should be construed narrowly to be defined only as the particular part being worked on. The Eleventh Circuit applied the narrower interpretation, finding that the insurer had a duty to defend.²¹⁰

In *United Specialty Ins. Co. v. Dorn Homes Inc.*,²¹¹ the court addressed the timing issues associated with exclusions (j)(5) and (6). Dorn, the general contractor of a residential home division project, sought coverage from its insurer after it made repairs to several homes following the discovery of defects in the homes including roof truss uplift and foundation edge uplift caused by grading and drainage issues. The insurer alleged that coverage for the repairs was barred by exclusions in the policy. On summary judgment, the court ruled in favor of Dorn on all "property damage" exclusions to coverage. Dorn argued that the exclusions did not apply because all damage arose after construction was completed on the homes, and the court agreed.²¹²

F. The "Your Work" Exclusion and the Subcontractor Exception

The concept of business risk—that the construction participant should be responsible for the quality of its own work—is particularly reflected in exclusion (l), the "your work" exclusion. This exclusion is commonly disputed in

construction defect cases. Although the exclusion applies to the defined term “your work,” it is subject to an exception for property damage arising out of work performed by a subcontractor. This subcontractor exception may provide a considerable amount of coverage for insureds that perform construction services through subcontractors. The exception was a concession by the insurance industry that the general contractor may be unable to monitor and control all the work of subcontractors, and that property damage arising out of such work is more fortuitous than work that a general contractor performs directly. The significance of the exception follows from the fact that self-performed work by a general contractor now appears to be the exception, rather than the rule, on complex construction projects. The “your work” exclusion states that the insurance does not apply to:

“Property damage” to “your work” arising out of it or any part of it and included in the “products-completed operations hazard.”

This exclusion does not apply if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor.

The exclusion by its terms applies to property damage to “your work,” defined in the policy as follows:

“Your Work” means:

- (1) Work or operations performed by you or on your behalf; and
- (2) Materials, parts or equipment furnished in connection with such work or operations.

Includes:

- (1) Warranties or representations made at any time with respect to the fitness, quality, durability, performance or use of “your work,” and
- (2) The providing of or failure to provide warnings or instructions.

In turn, the terms “you” and “your” as used in the CGL policy refer to the named insured. Moreover, the exclusion only applies to property damage within the “products-completed operations hazard,” defined to include:

All “bodily injury” and “property damage” occurring away from premises you own or rent and arising out of “your product” or “your work” except:

- (1) Products that are still in your physical possession; or
- (2) Work that has not yet been completed or abandoned. However, “your work” will be deemed completed at the earliest of the following times:
 - (a) When all of the work called for in your contract has been completed.
 - (b) When all of the work to be done at the job site has been completed if your contract calls for work at more than one job site.
 - (c) When that part of the work done at a job site has been put to its intended use by any person or organization other than another contractor or subcontractor working on the same project.

Work that may need service, maintenance, correction, repair or replacement, but which is otherwise complete, will be treated as completed.

The effect of the “your work” exclusion is to exclude coverage for all property damage to the named insured’s work arising out of it or any part of it occurring after completion. Because the term “your work” is defined in the policy to include work performed by the named insured or on its behalf, the exclusion, but for the explicit exception for property damage arising out of work performed by subcontractors, would also apply to subcontractor work. Because of the widespread use of subcontractors in the construction industry, the exception often preserves coverage for insureds, and, by virtue of the subcontractor exception, the named insured has coverage notwithstanding the exclusion for the following exposures:

- Property damage to work performed by the named insured when the damage results from the work of the named insured’s subcontractor;
- Property damage to work performed by the named insured’s subcontractor when the damage results from that subcontractor’s work;
- Property damage to work performed by the named insured’s subcontractor when the damage results from work performed by the named insured; and

- Property damage to work performed by the named insured's subcontractor when the damage results from the work of another contractor or subcontractor.²¹³

Insurance companies apparently determined that the construction industry would view the CGL policy as a more attractive product and that the CGL policy could be more salable if it provided coverage for property damage arising out of subcontractor work.²¹⁴ In addition, the extension of coverage to subcontractors' defective work was in accord with the notion that the insured should have coverage for liability to or because of work other than its own.²¹⁵

Overwhelmingly, case law upholds coverage for property damage arising out of the work of a subcontractor under an insured contractor's CGL policy. Many of these treatments of the subcontractor exception are found in conjunction with upholding the existence of an occurrence as defective construction, as discussed above. Of course, the Texas Supreme Court considered the subcontractor exception to the your work exclusion in its watershed opinion, *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*²¹⁶ There, the insured home builder sought CGL coverage for property damage arising out of the defective work of its subcontractor in constructing the foundation of a home, resulting in cracks in drywall and stone veneer throughout it. The court traced the expanded coverage provided under the CGL policy for certain business risks, recognizing the effect of the BFPD endorsement, which culminated in the insertion of the subcontractor exception into exclusion (I) of the 1986 form. By incorporating the subcontractor exception into the your work exclusion, the insurance industry specifically contemplated coverage for property damage caused by a subcontractor's defective performance. The court rejected the notion that the exception created coverage, finding rather that it reinstated coverage that would otherwise be excluded under that exclusion.

Other classic illustrative cases include *United States Fire Insurance Co. v. J.S.U.B., Inc.*²¹⁷ (the subcontractor exception to the "your work" exclusion provides coverage for property damage to homes arising out of subcontractor's defective site preparation); *Travelers Indemnity Co. America v. Moore & Associates, Inc.*²¹⁸ (damages resulting from the subcontractor's faulty installation of windows are not excluded from coverage, even if those damages affected the general contractor's own work); *Architex Ass'n, Inc., v. Scottsdale Insurance Co.*²¹⁹ (the subcontractor exception applies to property damage to a foundation resulting from defective installation of rebar by the named insured's subcontractor); *American Family*

*Mutual Insurance Co. v. American Girl, Inc.*²²⁰ (damage to a warehouse arising out of defective site preparation is within the exception, determining that conflicting authorities interpreting CGL policies that did not include the subcontractor exception are no longer controlling because the damage to an insured contractor's work caused by a subcontractor is within the subcontractor exception in the 1986 form); *Lee Builders, Inc. v. Farm Bureau Mut. Ins. Co.*,²²¹ (property damage to the surrounding structural components of a custom home that was caused by moisture seepage due to faulty work constituted an occurrence under the contractor's CGL policy, applying the subcontractor exception to the your work exclusion to uphold coverage); *Auto Owners Insurance Co. v. Newman*,²²² and *Crossmann Communities of N.C. v. Harleysville Mut. Ins. Co.*²²³ (the subcontractor exception preserved coverage for damage arising out of defective installation of EIFS by a subcontractor, which would otherwise be excluded under the "your work" exclusion). More recent cases continue the same pattern²²⁴.

Nevertheless, other courts have refused to apply the subcontractor exception to property damage arising out of a subcontractor's work. For example, in *Kvaerner Metals v. Commercial Union Insurance Co.*,²²⁵ the court held the subcontractor exception did not obviate the fact that faulty work on a coke battery resulting in damage to the battery itself was not an accident under the contractor's CGL policy.²²⁶

Note that other issues can arise in connection with the your work exclusion.²²⁷ For example, in *Com. Chem. Prods., Inc. v. Jake's Towing, L.L.C.*,²²⁸ the court interpreted the scope of the products-completed operations hazard under rather unique circumstances. The insured was contracted to repair an oil leak in a truck. After the work was completed, a technician drove approximately 200 feet away from the insured's shop despite the engine warning light being on, causing substantial damage to the engine. The court agreed that the insurer was not obligated to defend or indemnify the insured because even if the work was completed, the products-completed operations hazard did not apply because the truck was still on the insured's property when the damage occurred.²²⁹

Another issue is the scope of coverage for the named insured's own work, *i.e.*, work that does not involve subcontractors. In *American Home Assur. Co. v. Cat Tech, LLC*,²³⁰ Cat Tech, the insured, performed operations on a reactor, and property damage occurred within the products-completed operations hazard. The court considered three types of damages: (1) property damage to the specific parts that Cat Tech was working upon and upon which it performed defective work; (2) property damage to those

parts of the reactor on which Cat Tech performed non-defective work but were nonetheless damaged; and (3) damage to other parts of the reactor on which Cat Tech did not work.

Applying the your work exclusion, the court held that there was no coverage for the first two items of property damage, only for the third. In other words, coverage was excluded for the property damage to Cat Tech's own work, whether defective or non-defective.²³¹ The court reversed the trial court's grant of summary judgment in favor of the insurers and remanded the case back to the district court to make findings as to the scope of Cat Tech's work for purposes of the exclusion because the arbitration award for which Cat Tech sought coverage was ambiguous on that issue.

The breadth of the subcontractor exception to the "your work" exclusion led to the promulgation of a standard endorsement by ISO, CG 22 94 10 01, that modifies the "your work" exclusion by eliminating the subcontractor exception. By issuing the endorsement, ISO has, in effect, facilitated a significant reduction in coverage for many construction insureds. In *Lamar Homes, Inc. v. Mid-Continent Casualty Co.*,²³² the Supreme Court of Texas recognized the existence of this endorsement and its effect on coverage. Construction insureds need to pay careful attention at the time of insurance procurement to whether quoted CGL policies are subject to the endorsement, as a true determination of the relative cost and scope of coverage must consider the potentially significant effect of the presence or absence of the subcontractor exception. Additionally, particularly in the surplus lines market, insurers are more frequently crafting their own "enhanced" or "modified" your work or faulty workmanship exclusions.

G. The Your Product Exclusion

In interpreting earlier CGL policy forms, courts tended to intermix the concepts of the named insured's work and product. As a result, a product exclusion in most forms was sometimes interpreted to include the work of the contractor, or even the entire building as its "product." This often nullified the Broad Form Property Damage Endorsement to the policy that extended coverage in certain instances to defective work performed by the named insured, as discussed above.²³³

In 1986, Exclusion (k), the Your Product Exclusion, and the accompanying definition, added a real property exception to eliminate this issue. That exclusion states that the insurance does not apply to:

"Property damage" to "your product" arising out of it or any part of it.

In turn, the definition of "your product" provides:

21. "Your product"

a. Means:

- (1) Any goods or products, other than real property, manufactured, sold, handled, distributed or disposed of by:
 - (a) You;
 - (b) Others trading under your name; or
 - (c) A person or organization whose business or assets you have acquired; and
- (2) Containers (other than vehicles), materials, parts or equipment furnished in connection with such goods or products.

b. Includes:

- (1) Warranties or representations made at any time with respect to the fitness, quality, durability, performance or use of "your product"; and
- (2) The providing of or failure to provide warnings or instructions.

c. Does not include vending machines or other property rented to or located for the use of others but not sold.

The emphasized language, "other than real property" was intended to differentiate between completed construction projects and products. Insurance Services Office, Inc. (ISO) distributed a publication in connection with its promulgation of the 1986 policy form and stated the following as to the definition of "your product."

Real property is specifically eliminated from the definition of "your product" so that the broad form coverage for work and completed operations applies.²³⁴

Texas courts uphold this intent. In *United Fire Lloyds v. JD Kunz Concrete Contractor, Inc.*,²³⁵ the court determined that a defective parking lot fell within the exception for real property and was more akin to a building.

It relied upon *CU Lloyd's of Tex. v. Main Street Homes, Inc.*,²³⁶ for the proposition that in ordinary language, buildings are constructed or erected, not manufactured. Similarly, in *Wanzek Construction, Inc. v. Employers Ins. of Wausau*,²³⁷ the court undertook an extensive analysis of the intent behind the real property exception, concluding that custom coping installed by the insured in a swimming pool constituted part of its work, and was not subject to the your product exclusion.

Likewise, in *United Specialty Ins. Co. v. Dorn Homes Inc.*,²³⁸ the general contractor of a residential home division project, Dorn, sought coverage from its insurer after it made repairs to several homes following the discovery of defects in the homes including roof truss uplift and foundation edge uplift caused by grading and drainage issues. The insurer alleged that coverage for the repairs was barred by exclusions in the policy. On summary judgment, the court ruled in favor of Dorn on all "property damage" exclusions to coverage, including exclusion (k), the property damage to your product exclusion. USIC argued that Dorn sold decorative landscaping gravel to the homeowners, which was connected to the drainage issues, and that the decorative gravel fell outside of the real property exception to the exclusion (k). The court stated that Dorn did not actually sell the gravel to the homeowners, but rather, it was purchased by the subcontractors. Additionally, the court stated that the gravel "constituted an 'improvement,' if not a 'fixture' to the land," and thus fell into the exception to the your product exclusion.²³⁹

But not all construction-related claims are outside the exclusion. In *Building Specialties, Inc. v. Liberty Mut. Fire Ins. Co.*,²⁴⁰ the court held defectively installed insulation duct work fell within exclusion (k), the your product exclusion, because insulation ducts are more similar to components that are manufactured and later installed into a house or a building than completed buildings that were build, constructed, or erected.²⁴¹

H. Impaired Property Exclusion

The complexity of construction raises risks associated with construction related property damage, one of which is damage to neighboring or existing property. For example, assume that a contractor is hired to construct a major addition to a computer chip plant. In the course of doing so, it cuts off power to the plant, shutting it down and contaminating all the clean rooms, resulting in a total loss of product for several days. While the property damage to the electrical equipment may be relatively minimal, the damage to the clean rooms and the chips may be substantial. It is this risk of damage to other property that the impaired property exclusion is intended

to apply. Exclusion (m), added to the 1986 CGL form, states that the insurance does not apply to:

"Property damage" to "impaired property" or property that has not been physically injured, arising out of:

- (1) a defect, deficiency, inadequacy or dangerous condition of "your product" or "your work"; or
- (2) a delay or failure by you or anyone acting on your behalf to perform a contract or agreement in accordance with its terms.

This exclusion does not apply to the loss of use of other property arising out of sudden and accidental physical injury to "your product" or "your work" after it has been put to its intended use.

The 1986 revision also added the following definition of "impaired property" to the policy:

"Impaired property" means tangible property, other than "your product" or "your work," that cannot be used or is less useful because:

- (a) it incorporates "your product" or "your work" that is known or thought to be defective, deficient, inadequate or dangerous; or
- (b) you have failed to fulfill the terms of a contract or agreement;

If such property can be restored to use by:

- (a) the repair, replacement, adjustment or removal of "your product" or "your work" or
- (b) your fulfilling the terms of the contract or agreement.

A key to understanding the exclusion is that it applies to two different types of property damage: impaired property and property that has not been physically injured. The term "impaired property" is primarily directed to exclusion of damages for loss of use, as it is defined to include tangible property, other than the insured's product or work, that cannot be used or is less useful. The exclusion's reference to "property that has not been physically injured" appears directed to diminution in value claims where no property has been physically injured or destroyed. The insurance industry has continuously grappled with the "diminution in value" concept as a measure of damages for property that has not

been physically injured under the CGL policy, particularly under the definition of property damage. In 1973, ISO added the requirement that the property be physically injured under the definition of “property damage” in the policy. In addition, it has attempted to address the issue through predecessor exclusions to the impaired property exclusion.

Under Texas law, an example of an impaired property exclusion case is *Admiral Insurance Co. v. Little Big Inch Pipeline Co.*,²⁴² in which the court held that exclusion (m) barred coverage for diminution-in-value claims arising out of the insured subcontractor’s defective work in turning off natural gas service to a mobile home park because no property had been physically injured, and the loss arose out of the insured’s inadequate performance.

Another key factor in determining whether property is impaired for purposes of the exclusion is the status of the named insured. If the named insured is a general contractor that oversees the entire project, no portion of that project can constitute impaired property because the property is, by definition, impaired only if it is property *other than* the named insured’s work. A case illustrating this concept is *Corn Plus Co-Op v. Continental Casualty Co.*²⁴³ There, the court held that exclusion (m) barred coverage for the cost associated with the repair of the insured’s defective welding at an ethanol processing plant. The exclusion also applied to consequential damages, including loss of use of the plant and decreased ethanol production, because the plant itself was not the insured’s work—only the welding was—and the insured’s work impaired the rest of the plant.

In other words, the impaired property exclusion targets situations where a defective product, after being incorporated into the property of another, must be replaced or removed at great expense thereby causing a loss of use of the property.²⁴⁴ Moreover, the exclusion bars coverage for loss of use claims where the loss was caused solely by the insured’s failure to provide work of the quality or performance capabilities called for by the contract and where there has been no physical injury to property other than the insured’s work itself. The exclusion does not apply if there is damage to property other than the insured’s work or if the insured’s work cannot be repaired or replaced without causing physical injury to other property.²⁴⁵

The definition of “impaired property” is not met, and the exclusion does not apply where property cannot be restored to use by repairing the insured’s work.²⁴⁶

The issues involved in such scenarios were examined in depth by the Texas Supreme Court in *U.S. Metals, Inc. v. Liberty Mutual Group, Inc.*²⁴⁷ In that seminal case, the

insured manufactured and supplied defective weld neck flanges for installation in pipes in the “road diesel units” of two ExxonMobil refineries. After the flanges were installed and welded in place by a separate contractor, one of the flanges leaked during pressure testing, a small number exhibited anomalies upon examination, and none of the 300 flanges met specification. ExxonMobil determined that the flanges were defective, decided to remove and replace them all, and then sought damages from the insured for the costs associated with investigating, removing, and replacing the defective flanges, together with the loss of use of its refineries.

The manufacturer’s insurer denied coverage, and the insured filed a declaratory judgment action, seeking coverage for its settlement with ExxonMobil. There was no claim as to the defective flanges themselves because exclusion (k), the your product exclusion, applied to those damages. As to the costs of cutting out the flanges from the pipes, the major component of damages, the insurer argued that there had been no “physical injury” to the road diesel units and that those costs were merely part of repairing or replacing the defective flanges and therefore, were excluded. The court held that the incorporation of a defective component in and of itself is not property damage in the absence of physical injury to tangible property but went on to consider the definition of “impaired property” and the exclusion.²⁴⁸

But the court further held that the loss of use of the diesel units into which the defective flanges were installed were restored to use by replacing the flanges and thus, were impaired property to which the exclusion applied. However, the court also found that insulation and gaskets in the flanges that were destroyed in the course of replacing the flanges were not restored to use and had to be replaced. Therefore, the court held that the insulation and gaskets did not constitute “impaired property” to which exclusion (m) applied, and the cost of replacing them was therefore covered by the policy.²⁴⁹

This portion of the opinion appears to uphold “rip and tear” coverage to Texas contractors, in that the cost of ripping and tearing out good work to repair defective work may be covered property damage. This aspect of the *U.S. Metals* reasoning has been followed by subsequent opinions. In *Amerisure Mutual Insurance Co. v. McMillin Texas Homes*,²⁵⁰ defective stucco was alleged to have damaged other property and there were no allegations in the petitions that repair of the stucco exterior would only be a preventative measure, intended to avoid the “risk” of future property damage. The factual allegations potentially supported a covered claim for tear-out costs and thus invoked the insurer’s duty to defend.

Moreover, in *Travelers Lloyds Ins. Co. v. Cruz Constr. of Tex.*,²⁵¹ the insurer asserted that the impaired property exclusion applied because the roadways were in fact restored to use by repair, replacement, adjustment, or removal of the defective work. Thus, according to Travelers, the roadways were “impaired property” under the policies, and the damage associated with the loss of use occurring to repair, replace, adjust, and remove the defective work was excluded from coverage. However, the insured argued the utility lines, roads, curbs, and parkways that were damaged as a result of the defective utility work were not excluded impaired property because the damage to that property could not be restored to use by the repair, replacement, adjustment, or removal of Cruz’s underlying defective work. The court ultimately determined that Travelers was required to show that the property damage would be entirely repaired by simply fixing or removing the defective work, but nothing in the record demonstrated that simple a solution. Therefore, the court concluded that the property damage to the work of other contractors was not “impaired property” to which the exclusion applied.²⁵²

*U.S. Metals*²⁵³ was also relied upon in *Midwest Fam. Mut. Ins. Co. v. Green Fuel Techs.*²⁵⁴ There, the insured general contractor sought coverage for replacement of a subcontractor’s faulty concrete that failed to meet strength requirements. The concrete having already been poured, the general contractor removed and replaced the faulty concrete along with other plumbing and electrical work that was previously completed. The insurer denied coverage based upon exclusion (m), the impaired property exclusion. In response to the insurer’s argument, the court emphasized that “the damage claimed is for non-defective property that had to be replaced because of [d]efendant’s allegedly defective concrete.”²⁵⁵ The court cited *Black & Veatch Corp. v. Aspen Ins. (Uk) Ltd.*,²⁵⁶ and *U.S. Metals*,²⁵⁷ stating that exclusion (m) should not apply to eliminate coverage where the incorporation of the defective work or product did no actual physical damage to tangible property but the removal or repair of that work or product has or will physically injure other property. The entire exclusion (m) is also subject to an exception for sudden and accidental physical injury to the named insured’s work after it has been put to its intended use. For example, in *Mississippi Phosphates Corp. v. Furnace & Tube Service, Inc.*,²⁵⁸ the court held that the impaired property exclusion did not exclude coverage for loss of use of a sulfuric acid plant arising out of the sudden and accidental injury to the plant after the water boiler worked on by the insured was put to its intended use.

The court reached the opposite result on differing facts in *BITCO General Ins. Corp. v. Union Ridge Ranch, LLC*.²⁵⁹ In that case, the insured contractor was hired to construct retaining walls and perform other concrete work at a housing development site. Subsequently, geotechnical reports indicated that there were numerous defects in the insured’s work on the retaining walls and other items of work. BITCO denied the owner’s claims for losses upon being forced to sell the project at a reduced sale price and for additional interest and fees paid to lenders and attorneys. The owner and the insured entered a settlement agreement and a covenant not to execute. BITCO denied the claim based on exclusion (m), and the definition of “impaired property, that is, “property other than the insured’s product or work that cannot be used or is less useful because of its failure to fulfill the terms of a contract or agreement.” The insured looked to the exception to the exclusion that it does not apply to loss of use or other property arising out of sudden and accidental physical injury to the insured’s product or work after it has been put to its intended use. The court rejected that argument finding that the damage occurred over time.²⁶⁰ The court also accepted the argument that the exception could not apply because the losses were not the result of the wall’s failure but were instead the result of buyers concluding that the insured had performed poor workmanship and consequently lost confidence in the project as a whole.

I. Product Recall (Sistership) Exclusion

Another exclusion sometimes cited in the construction defect context is exclusion (n), the product recall exclusion, which states that the insurance does not apply to:

Damages claimed for any loss, cost or expense incurred by you or others for the loss of use, withdrawal, recall, inspection, repair, replacement, adjustment, removal or disposal of:

- (1) “Your product”;
- (2) “Your work”; or
- (3) “Impaired property”;

If such work, or property is withdrawn or recalled from the market or from use by any person or organization because of a known or suspected defect, deficiency, inadequacy or dangerous condition in it.

Exclusion (n) is historically known as the “sistership exclusion” because of the underwriting intent at the time it was first drafted: to deny coverage for claims based

upon the cost of withdrawing a product from the market, replacing a product, or the loss of use of a product that is temporarily or permanently withdrawn from the market because of occurrences involving the same or a similar product. That intent was explained in *Gulf Insurance Co. v. Parker Products, Inc.*²⁶¹ The name “sistership exclusion” derives from an occurrence in the aircraft industry where all airplanes of a certain make and type were grounded by an order of the Civil Aeronautics Administration because one airplane crashed and others were suspected of having a common structural defect. The damages arising out of the loss of use of all of the sister ships were enormous.

The recall of equipment or parts discovered to have a common fault involves expenses incurred to prevent accidents that have not occurred. While the insurance covers damages for bodily injuries and property damage caused by the product that failed, it never was intended that the insurer would be saddled with the cost of preventing other failures, any more than it was intended that the insurer would pay the cost of preventing the first failure if the product had been discovered to be in a dangerous condition before the occurrence.²⁶² The product recall exclusion applies *only* to damages claimed for any loss, cost, or expense incurred if a product is withdrawn or recalled from the market because of a known or suspected defect.²⁶³

In *Auto Owners Insurance Co. v. Newman*,²⁶⁴ however, after finding that coverage for property damage arising out of the installation of defective stucco by the insured homebuilder’s subcontractor caused water infiltration damage to a home, the court went on to apply the product recall exclusion, even though the property damage was to a single home and did not involve the withdrawal of any other homes from the market or use. Moreover, it was not clear from the opinion whether the damaged property was ever withdrawn from use. The court held that the exclusion applied to the cost of removal and replacement of the defective stucco, determining that those costs fell within the exclusion as the cost of repair and replacement of the insured’s work that was withdrawn from use because of a defect.²⁶⁵ Again, the application of the exclusion under these circumstances is open to question, especially where the subcontractor exception expressly preserves coverage for the cost of repairing and replacing property damage caused by the defective work of subcontractors, including the work of the subcontractor itself. While in a distinct minority, the South Carolina Supreme Court reinforced its reliance on the exclusion in the construction defect context in *Bennett & Bennett Constr., Inc. v. Auto Owners Ins. Co.*,²⁶⁶ again glossing over the lack of a recall issue as to the defective work.

J. Electronic Data Exclusion

One of the more recent and significant developments in the design and construction industry has been the development of building information modeling (BIM) and virtual design in construction. Under that system, software allows the participants in the construction project to create a three-dimensional digital model of the physical and functional aspects of a building from initial planning through operation. This virtual construction allows for the integration of building systems into the single project and promotes efficiency.

Virtual construction is an example of the industry’s move toward the use of electronic data in everyday operations, which mirrors the growth of electronic data and artificial intelligence in the business world overall. In that connection, the CGL policy’s definition of “property damage” now states that electronic data is not tangible property:

For the purposes of this insurance, electronic data is not tangible property. As used in this definition, electronic data means information, facts or programs stored as or on, created or used on, or transmitted to or from computer software, including systems and applications software, hard or floppy disks, CD-ROMS, tapes, drives, cells, data processing devices or any other media used with electronically controlled equipment.

In addition, beginning with the 2004 edition of the standard CGL form, exclusion (p), the electronic data exclusion, was added to the policy, stating that the insurance does not apply to:

Damages arising out of the loss of, loss of use of, damage to, corruption of, inability to access, or inability to manipulate electronic data. As used in this exclusion, electronic data means information, facts or programs stored as or on, created or used on, or transmitted to or from computer software, including systems and applications software, hard or floppy disks, CD-ROMS, tapes, drives, cells, data processing devices or any other media which are used with electronically controlled equipment.

These changes to the standard CGL language are still relatively new, and it is uncertain how broadly the courts will apply them, although litigation is sure to ensue in light of the increasing use of electronic media in the construction and design industries. Note however, that new insurance products addressing cyber and other potential electronic liabilities have already emerged.

X. EXCLUSIONARY ENDORSEMENTS

A. Breach of Contract Exclusionary Endorsements

As pointed out previously, many insurers have sought to exclude defense and indemnity for construction defect damages through arguing that exclusion (b), the contractual liability exclusion, applies to garden variety breach of contract claims. In other words, by sleight of hand and hocus pocus, the contractual liability exclusion morphs into a breach of contract exclusion applicable to direct claims against the insured. Unbelievably, a number of courts have been transfixed by those arguments and denied legitimate claims.

The refusal of most courts to buy into these arguments led to the addition of “breach of contract” endorsements by certain insurers. The endorsements modified a contractor’s CGL policy to drastically reduce the coverage for construction defect claims. “Breach of contract” exclusions appear to trace their current popularity to the landmark cases in which state supreme courts held that property damage arising out of defective workmanship can constitute an occurrence.

Courts began to embrace the underwriting intent behind the policy to determine that, in many instances, defective workmanship constituted an “occurrence” of “property damage” under the policy definitions, as discussed above. In those cases, the courts placed heavy emphasis on the subcontractor exception to exclusion (l), the your work exclusion in the CGL policy, to demonstrate that unexpected and unintended property damage arising out of a breach of contract or negligence constituted an occurrence under the policy, and that the subcontractor exception preserved that coverage. However, in doing so, the Supreme Court of Texas in *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*²⁶⁷ observed that in the event insurers desired to eliminate coverage for the subcontractor exception, they could simply endorse the policy, noting that ISO had already issued endorsement CG 22 94 10 01 that could be included in a CGL policy to eliminate the subcontractor exception (and much of the coverage available to construction insureds). Further, in *U.S. Fire Ins. Co. v. J.S.U.B., Inc.*,²⁶⁸ the Florida Supreme Court observed that if an insurer intended to preclude coverage based on the cause of action asserted (i.e., breach of contract), it was incumbent on the insurer to include clear language to accomplish a “breach of contract” endorsement exclusion.

It is obvious that the Texas and Florida Supreme Courts referred to attachment of a breach of contract endorsement to the standard CGL policy as part of their

legal analysis of the failure of the insurance industry to have addressed the issue in the policies before them, a standard method of policy interpretation. But some insurers regarded this dictum as an invitation to drastically cut back the scope of coverage offered to the construction industry in their CGL policies. Some insurers seem to require little incentive to attach coverage reducing endorsements to the back of their policies. Unfortunately for construction insureds, one of the most effective endorsements of that type is the breach of contract endorsement. There are no standardized breach of contract endorsements, so they are written on a manuscript basis. Examples of typical endorsements addressed in the case law are as follows:

Example 1:

This insurance does not apply to “claims” for breach of contract, whether express or oral, nor “claims” for breach of an implied in law or implied in fact contract, whether bodily injury, property damage, or advertising injury, personal injury, pollution incident, cleanup costs, or an occurrence is alleged.²⁶⁹

Example 2:

This insurance policy does not apply, nor do we have a duty to defend any claim or “suit” for “bodily injury,” “property damage,” or “personal and advertising injury” arising directly or indirectly out of the following:

- a. Breach of express or implied contract;
- b. Breach of express or implied warranty;
- c. Fraud or misrepresentation regarding the formation, terms, or performance of a contract; or
- d. Libel, slander, or defamation arising out of or within the contractual relationship.²⁷⁰

Example 1 above is of a limited variety and does not affect negligence claims. Unfortunately, not all breach of contract endorsements are limited in scope to breach of contract claims, so the moniker “breach of contract” exclusion is something of a misnomer. Example 2 above obviously includes many more types of claims than a plain vanilla breach of contract in that it excludes claims for bodily injury or property damage “arising directly or indirectly” out of breach of contract. Rather, it is much broader, encompassing even more obtusely, bodily injury. Despite their breadth, courts have upheld the plain language of these exclusions.²⁷¹

However, in one of the earliest reported cases to interpret the broad endorsement, the exclusion did not survive the commonsense scrutiny of the court. In *Mt. Hawley Ins. Co. v. Aguilar*,²⁷² Mt. Hawley argued the exclusionary endorsement should be broadly applied because it was directed at property damage “arising directly or indirectly” out of breach of contract. However, the court rejected that argument, finding Mt. Hawley’s broad interpretation was unreasonable, and the court instead took a practical approach given the nature of the construction industry. The court held that, since a subcontractor almost always enters into an oral or written contract when performing work on a construction project, the court was “hard pressed to identify a scenario in which an insured-subcontractor would be entitled to coverage” under the policy.²⁷³ Therefore, the court refused to allow the breach of contract exclusion to be relied on to defeat all coverage for construction defect claims, thoroughly rejecting the restriction on coverage asserted by the insurer.

Unfortunately for insureds, cases such as *Aguilar* refusing to enforce the exclusion are relatively few and far between. However, in *Cincinnati Specialty Underwriters Ins. Co. v. KNS Group, LLC*,²⁷⁴ the court refused to apply the breach of contract exclusion in a suit alleging defective installation of a glass façade by the insured. Allegations against the insured involved negligence, common law indemnification, and contribution. In response, the insurer contended that the causes of action asserted against the insured were all grounded on its purported breach of contract.

The court held that under the insurer’s position, the mere existence of a contractual relationship among the parties could create an absolute bar to coverage. It further held that if the insurer intended to include such a broadly interpreted exclusion so that a contractual relationship gave rise to the exclusion, it should have drafted the endorsement as such. Therefore, the insurer’s interpretation of the exclusion was unsupported under Florida law.²⁷⁵

The broad language employed in the breach of contract exclusion renders it extremely treacherous when applied to coverage for construction defect claims involving breach of contract. An insurance policy is a contract, and when interpreting a contract, every court is tasked under the law to apply its terms according to the intentions of the parties to it. But a contract is a mere piece of paper that cannot testify as to what the parties intended. Therefore, the best evidence of the parties’ intent is the words of the contract itself. If the contract, or policy, is

written in plain language, a court is likely to enforce it, even if the enforcement of the contract works a hardship on one party, such as an insured contractor. Only if the contract is ambiguous, that is, subject to two reasonable interpretations, will the court break the tie in favor of the insured.

Exclusion of coverage for breach of contract in an industry that engages in complex and dangerous operations through complex contracts is certainly contrary to the intent of any contractor. However, the attachment (or effect of the attachment) of a breach of contract endorsement to a CGL policy may go unnoticed until it is too late after the occurrence of a claim.

A contractor, and certainly its insurance broker or agent during negotiation or upon policy issuance, or its lawyer if given an opportunity to review the policy, should attempt to reject the attachment of such an endorsement to the policy. The entire policy must be reviewed and understood to avoid post-claim surprises.

The coverage under a CGL policy should never be taken for granted as “standard.” Insurers make major revisions to limit coverage but still market the policy as a “CGL” or “commercial general liability” policy. While it may still be labeled “CGL,” in reality, a policy endorsed with a breach of contract exclusion provides much less than “general liability” coverage. Unfortunately, these policies are often issued to parties that have more than marginal risks and can least afford an uninsured loss.

It would be somewhat odd to read the exclusion to apply to property damage arising out of a breach of contract by any party, including subcontractors, who are strangers to the “excluded” targeted contract. In addition, it is possible that the breach of contract claim may not dispose of all allegations of property damage in the claim against the insured. Finally, reading the subcontractor exception out of the policy would impermissibly render much coverage under the policy illusory.

This is especially true where the means employed to accomplish that is a “breach of contract exclusion” and not the standard form that eliminates the subcontractor exception. It is difficult to see how the attachment of such an endorsement to a CGL or umbrella policy issued to a construction insured can be justified.

B. Professional Liability Endorsements

Because of blurring lines between traditional design and construction, most CGL policies issued to construction industry participants contain exclusions for traditional architectural, engineering, and supervision activities

by the insured. A good deal of variation exists among endorsements attached to policies for this purpose, and special care should be used in reviewing them. Generally, for traditional design-bid-build projects, the ISO CG 22 79 endorsement should be used because it preserves coverage for incidental design services performed as a part of a contractor's construction means and methods as set out in the following savings clause:

Exclusion—Contractors—Professional Liability

1. This insurance does not apply to “bodily injury”, “property damage” or “personal and advertising injury” arising out of the rendering of or failure to render any professional services by you or on your behalf, but only with respect to either or both of the following operations:
 - a. Providing engineering, architectural or surveying services to others in your capacity as an engineer, architect or surveyor; and
 - b. Providing, or hiring independent professionals to provide, engineering, architectural or surveying services in connection with construction work you perform.

This exclusion applies even if the claims against any insured allege negligence or other wrongdoing in the supervision, hiring, employment, training or monitoring of others by that insured, if the “occurrence” which caused the “bodily injury” or “property damage”, or the offense which caused the “personal and advertising injury”, involved the rendering of or failure to render any professional services by you or on your behalf with respect to the operations described above.

2. Subject to Paragraph 3. below, professional services include:
 - a. Preparing, approving, or failing to prepare or approve, maps, shop drawings, opinions, reports, surveys, field orders, change orders, or drawings and specifications; and
 - b. Supervisory or inspection activities performed as part of any related architectural or engineering activities.

3. Professional services do not include services within construction means, methods, techniques, sequences and procedures employed by you in connection with your operations in your capacity as a construction contractor.

On the other hand, where a contractor provides design services itself, ISO endorsement CG 22 80 should be used where available:

Limited Exclusion—Contractors—Professional Liability

This insurance does not apply to “bodily injury”, “property damage” or “personal and advertising injury” arising out of the rendering of or failure to render any professional services by you, but only with respect to your providing engineering, architectural or surveying services in your capacity as an engineer, architect or surveyor.

Professional services include:

1. Preparing, approving, or failing to prepare or approve, maps, shop drawings, opinions, reports, surveys, field orders, change orders, or drawings and specifications; and
2. Supervisory or inspection activities performed as part of any related architectural or engineering activities.

This exclusion applies even if the claims against any insured allege negligence or other wrongdoing in the supervision, hiring, employment, training or monitoring of others by that insured, if the “occurrence” which caused the “bodily injury” or “property damage”, or the offense which caused the “personal and advertising injury”, involved the rendering of or failure to render any professional services by you with respect to your providing engineering, architectural or surveying services in your capacity as an engineer, architect or surveyor.

This exclusion does not apply to your operations in connection with construction work performed by you or on your behalf.

Coverage gaps within the CGL policy for professional design exposures are usually filled by insured contractors by purchasing professional liability coverage, including a contractors professional liability policy or coverage.

C. Habitational Exclusionary Endorsements

The wave of litigation involving defects in residential construction attracted not only the attention of the construction industry, plaintiffs' lawyers, and homeowners associations, but also the insurance industry. The potentially staggering liability associated with completed operations claims brought by multitudes of plaintiffs in a single lawsuit spawned the attachment of "habitational" endorsements designed to exclude coverage for claims arising out of not only single-family homes or multifamily condominium developments but also apartments, assisted living facilities, nursing homes, hospitals, military housing, and other similar construction projects. These endorsements are manuscripted (that is, written by specific insurance companies, as opposed to ISO forms) and should be tailored to the needs of particular insureds. For example, an apartment developer may have a residential exclusion on its policy, but it usually specifically excepts apartment projects. Nevertheless, problems can arise even with these types of endorsements in the event an apartment project is sold and later converted into condominiums. If the apartment developer's policy includes a habitational endorsement that applies to condominiums, the issue arises as to whether it would apply to the converted project. A court will enforce the habitational endorsement and deny coverage²⁷⁶

This is what the court did in *Ment Bros. Iron Works Co., Inc. v. Interstate Fire & Cas. Co.*,²⁷⁷ involved conversion issues where the insured welding subcontractor sought a declaratory judgment regarding its insurer's obligations as to property damage that had been caused during construction of a residential building. The habitational endorsement in its policy excluded property damage arising out of the construction of residential properties, except apartments. The term "residential properties" was defined to include condominiums, while an "apartment" was defined as a unit of residential real estate in a multi-unit residential building or project where all units are owned by and titled by a single person or entity. Therefore, the court determined the property was an apartment.²⁷⁸

However, the exclusion further stated that it would apply in the event of conversion of an apartment into a condominium. The court further determined that, at the time of the property damage, the project was an apartment building rather than a condominium based on the title to the property. The court held that there was no claim or evidence that any unit of the planned condominium had been transferred when the insured finished performing its

welding subcontract in the summer of 2006. In essence, the court held that the apartment was not a condominium until *after* conversion, and the habitational exclusion specifically stated that in the event of conversion, "*then* coverage under this policy is excluded."²⁷⁹ The insurer did not contest that at the time the property damage occurred, the project was owned and titled to a single owner.

In *Nautilus Ins. Co. v. Pinnacle Eng'g & Dev. Inc.*,²⁸⁰ the insurer and insured contractor filed cross-motions for summary judgment as to the applicability of a residential construction exclusion to property damage to a defectively constructed condominium project arising out of defective work performed by the insured. The court entered summary judgment in favor of the insurer, determining that the exclusion unambiguously applied to the project consisting of 18 detached structures made up of 57 units.²⁸¹

Conversions aside, it is the completed operations exposure as to a past project that poses the greatest risk for contractors. This is because the operative CGL policy at the time of the property damage may contain a habitational endorsement. A contractor must be sure to understand the import of the attachment of such an endorsement on the insurability of its operations and its completed operations. Only then can it undertake informed consideration of alternative means, if any, to deal with that exposure.

D. Wrap-Up (Controlled Insurance Program) Exclusions

Due to the presence of multiple parties in proximity and contractual relationships between those parties on a construction project, as well as the inherent dangers, the construction industry has traditionally presented unique challenges to the insurance industry in terms of insured risks. Both the elimination of duplicative insurance coverage and inherent conflicts between insurers as to a specific claim spurred the desire to achieve economies of scale and cost savings through a policy insuring all parties on the project. Moreover, the ability to theoretically provide better coverage increased the impetus of many owners and general contractors to consider this option. In addition, the high cost of separate insurance programs maintained throughout the tiers was a significant factor underpinning the development of wrap-ups. Though they have now been around for a number of decades, issues continue to arise as to the operation of wraps and the parties' corporate insurance programs.

A wrap-up is an insurance/risk management/safety program provided by the owner (OCIP) or the general contractor (CCIP) to all of the parties on a construction

project, usually extending beyond the duration of the project for an extended period, usually to the length of the statute of repose. The wrap-up typically includes CGL, workers compensation and employers liability, and umbrella liability insurance. Most tiers are covered, including the general contractor, subcontractors, and sub-subcontractors through the lower tiers. Smaller subcontractors, offsite fabricators, and suppliers are usually not included.

One of the key considerations in a wrap-up is the avoidance of overlap between the participants' own insurance and the wrap-up insurance program. If there is a lack of coordination, it could defeat the purpose of the program. With that in mind, ISO promulgated standard endorsement CG 21 54 01 96 that provided that the insureds' insurance policies, to which it was attached, provided no operations or products-completed operations coverage for a project that had been covered by a wrap-up insurance program. Such is true regardless of whether coverage was identical to that provided in the attached policy; the limits were adequate to cover all claims; or the wrap-up was cancelled or the insurer became insolvent; or the wrap-up was otherwise no longer in effect. This exclusion can cause problems for insureds where the wrap-up was no longer in effect or was inadequate. Courts routinely upheld the exclusion.²⁸²

Fortunately, the endorsement was revised in 2019 in an effort to eliminate certain gaps and ambiguities. That endorsement included a provision stating that "this exclusion does not apply if the 'controlled (wrap-up) insurance program' in which you are enrolled with respect to the 'bodily injury' or 'property damage' ... has been cancelled, nonrenewed or otherwise no longer applies for reasons other than the exhaustion of all available limits, whether such limits are available on a primary, excess or on any other basis. You must advise us of such cancellation, nonrenewal or termination as soon as practicable." Thus, the draconian nature of the original wrap-up exclusion has now been somewhat tempered by the exception for cessation of the wrap-up, and for exhaustion of limits.

A more secure way for an insured contractor to ensure that its own coverage remains in effect in the face of a wrap-up is to obtain a wrap-up excess/DIC endorsement that states that its corporate insurance will apply on an excess or difference in conditions basis over any coverage available under a wrap up insurance program. This type of endorsement should provide the insured wrap-up participant with greater protection.

Nevertheless, wrap-ups require additional administrative detail as illustrated by *Soule v. Woodward Design + Build, LLC*.²⁸³ In *Soule*, the general contractor sponsored a contractor controlled insurance program for a condo construction project. One of its subcontractors did not complete its enrollment in the CCIP but paid premiums to the general contractor for CCIP coverage. After an elevator/hoist fell injuring several workers, the subcontractor tendered the claim to its corporate CGL insurer. The CGL policy contained an exclusion for work performed that "is or was to be insured under a consolidated (wrap-up) insurance program." The court agreed with the insurer that the fact that the subcontractor failed to enroll properly in the CCIP was irrelevant to the interpretation of the CGL policy.²⁸⁴ As a result, the subcontractor was left without insurance even though it had been paying premiums for both policies.

At the same time, a troublesome exclusionary endorsement to a typical wrap-up policy bears mentioning. A wrap-up policy usually modifies the customary CGL property damage exclusions, deleting Exclusions j(5) and j(6), the operations and incorrect work exclusions. As described above, those standard exclusions apply to operations in progress, stating that the insurance does not apply to property damage to "**that particular part**" of real property on which the named insured or its subcontractors are performing operations, if the property damage arises out of those operations, or if the property must be restored, repaired, or replaced because the named insured's work was incorrectly performed on it. The "that particular part" formulation is intended to preserve coverage for other property damaged by the particular part.

One might be tempted to believe that deletion of the standard j(5) and(6) exclusions is a win for the insured participants and that coverage would be increased by the deletion of exclusions. Unfortunately, the deletion of these property damage exclusions from the CGL form is usually accompanied by attachment of a considerably more onerous and absolute endorsement to the wrap-up policy, stating that the insurance does not apply to property damage at or to the insured project during the course of construction or operations (*i.e.*, before the substantial completion of the project). Gone is the "that particular part" limitation, and the modification is often made through a stand-alone endorsement that may be labeled in various ways, such as "Property Damage to Work in Progress," "Course of Construction Endorsement," "Property Damage to Contract Works," or "Exclusion — Damage to the Project During the Course of Construction."

Insurance underwriters often refer to this type of provision as the “builders risk exclusion,” apparently on the assumption that builders risk insurance, rather than liability insurance, should provide coverage for property damage to the work that occurs during the course of construction. This overly simplistic approach ignores the fact that builders risk policies contain many gaps in coverage versus a standard CGL policy, particularly as to defective construction. The exclusion can thus create a significant gap for participants in a wrap-up project for property damage occurring during the course of operations, depending on their ability to coordinate and rely upon coverage within their own insurance policies.

First and foremost, a builders risk policy is a first-party property policy that does not include a defense obligation for the insurer. Therefore, when the insured looks to the wrap-up CGL policy for defense of a claim involving property damage during construction, it may be excluded, and no defense is available under the wrap-up policy. In addition, coverage for certain consequential damages may be excluded under a builders risk policy but may otherwise be covered under a CGL policy but for a course of construction exclusion attached to a wrap-up policy.

Course of construction exclusions have been enforced by courts.²⁸⁵ Nevertheless, the Eleventh Circuit in *Liberty Surplus* noted construction industry concerns voiced by the Associated General Contractors of America and the National Association of Home Builders, as amici curiae, calling the court’s attention to the incongruity in denying course of operations coverage under a wrap-up program that is designed to provide effective coverage for all participants on a large project. Unfortunately, the court decided not to address that issue because the builders risk policy was not included in the court record. The result in the *Liberty Surplus* case seems somewhat less than ringing, but the court’s observations moved the needle slightly toward possible modification of course of construction exclusions in wrap-up policies.

Endnotes

¹ This article contains excerpts from Insurance for Defective Construction, Sixth Edition, by Patrick J. Wielinski and published by International Risk Management Institute of Dallas in August 2023, as well as from the Commercial General Liability Chapter of Construction Insurance, co-authored with Lee Shidlofsky for the ABA Forum on Construction Law in 2011, a second edition of which has been revised and is soon to be re-published.

² *Gilbert Tex. Constr., L.P. v. Underwriters at Lloyd's London*, 327 S.W.3d 118 (Tex. 2010).

³ *Country Pool & Spas, Inc. v. Erie Ins. Exch.*, 2024 WL 799580, 315 A.3d 110 (Pa. Super. 2024).

⁴ *Id.* at *6.

⁵ *Id.* at *5.

⁶ *Kelley-Coppedge, Inc. v. Highlands Ins. Co.*, 980 S.W.2d 462, 464 (Tex. 1998) (citing *Nat'l Union Fire Ins. Co. v. CBI Indus., Inc.*, 907 S.W.2d 517, 520 (Tex. 1995)).

⁷ *Kelley-Coppedge, Inc.*, 980 S.W.2d at 465.

⁸ *Glover v. National Ins. Underwriters*, 545 S.W.2d 755, 761 (Tex. 1977).

⁹ *ZZZ Carpentry, Inc. v. Mt Hawley Ins. Co.*, 225 A.D.3d 562 (N.Y. Ct. App. 2024).

¹⁰ *Id.*

¹¹ *JAW The Pointe, L.L.C. v. Lexington Ins. Co.*, 460 S.W.3d 597 (Tex. 2015).

¹² 21 ERIC MILLS HOLMES, HOLMES' APPLEMAN ON INSURANCE § 129.1[C] (2d ed. 2002).

¹³ *United States Fire Ins. Co. v. J.S.U.B., Inc.*, 979 So. 2d 871 (Fla. 2007).

¹⁴ *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 242 S.W.3d 1 (Tex. 2007).

¹⁵ *Id.* at 11.

¹⁶ See, e.g., *Essex Builders Group, Inc. v. Amerisure Ins. Co.*, 429 F. Supp. 2d 1274 (M.D. Fla. 2005); *Fid. & Deposit Co. of Md. v. Hartford Cas. Ins.*, 189 F. Supp. 2d 1212 (D. Kan. 2002); *Am. Oil Co. v. L. A. Davidson, Inc.*, 290 N.W.2d 144 (Mich. Ct. App. 1980). See also Joanne Brooks et al., *The Importance of Insurance Coverages for Sureties* (ABA Forum on the Construction Industry/Tips Fidelity & Surety Law Committee Joint Program Mid-Winter Meeting 2005).

¹⁷ See generally *Essex Ins. Co. v. Holder*, 261 S.W.3d 456 (Ark. 2003), relying upon *Nabholz Construction Corp. v. St. Paul Fire & Marine Ins. Co.*, 354 F. Supp. 2d 917 (E.D. Ark. 2005).

¹⁸ See *Lexicon, Inc. v. ACE Am. Ins. Co.*, 634 F.3d 423, (8th Cir. 2011) (applying Arkansas law).

¹⁹ The CGL policy also includes a separate insuring agreement for Coverage B as to personal and advertising injury liability coverage. This insuring agreement is of less importance to construction insureds.

²⁰ *Data Specialties, Inc. v. Transcontinental Ins. Co.*, 125 F.3d 909 (5th Cir. 1997).

²¹ *Vandenberg v. Centennial Ins. Co.*, 982 P.2d 229 (Cal. 1999).

²² See *Ritchie v. Anchor Cas. Co.*, 286 P.2d 1000 (Cal. Ct. App. 1955).

²³ *McDonald Construction Company, Inc. v. Bituminous Casualty Corp.*, 632 S.E.2d 420 (Ga. Ct. App. 2006).

²⁴ *Id.* 424.

²⁵ *Ohio Casualty Ins. Co. v. Time Warner Entertainment Co., L.P.*, 244 S.W.3d 885 (Tex. App.—Dallas 2008, pet. denied); *Detroit Water Team Joint Venture v. Agricultural Insurance Co.*, 371 F.3d 336 (6th Cir. 2004). Both of these cases stand for the proposition that a legal obligation under the insuring agreement of the CGL agreement must be established by judgment or settlement.

²⁶ *Wanzek Construction, Inc. v. Employers Ins. of Wausau*, 667 N.W.2d 473 (Minn. Ct. App. 2003), *aff'd*, 679 N.W.2d 322 (Minn. 2004).

²⁷ *Id.* at 322 (“The language is broad and general enough to pertain to Wanzek’s claim, which involves property damage and an apparent contractual obligation on Wanzek’s part to repair or pay for the property damage. And nothing in the provision suggests that a lawsuit is necessary to trigger coverage.”).

²⁸ *Venture Encoding Serv., Inc. v. Atlantic Mut. Ins. Co.*, 107 S.W.3d 729 (Tex. App.—Fort Worth 2003, pet. denied).

²⁹ *Lennar Corp. v. Great American Ins. Co.*, 200 S.W.3d 651 (Tex. App.—Houston [14th Dist.] 2006, pet. denied).

³⁰ *Id.* at 680.

³¹ *Id.*

³² George H. Tinker, *Comprehensive General Liability Insurance: Perspective and Overview*, 25 FED’N. INS. COUN. Q. 217, 222 (Spring 1975).

³³ *Lennar Corp. v. Markel Am. Ins. Co.*, 413 S.W.3d 750 (Tex. 2013).

³⁴ TEX. PROP. CODE §§ 27.001-009.

³⁵ But see *Amerisure Mut. Ins. Co. v. McMillin Texas Homes*, 2022 WL 686727 (W.D. Tex. Mar. 3, 2022) (based on the procedural posture of RCLA demands as pre-suit claims, and not the substance of their allegations, the court concluded that they did not trigger the insurer’s duty to defend, which was apparently not disputed by the insured).

³⁶ *Altman Contractors, Inc. v. Crum & Forster Specialty Ins. Co.*, 124 F. Supp. 3d 1272 (S.D. Fla. 2015).

³⁷ *Altman Contractors, Inc. v. Crum & Forster Specialty Ins. Co.*, 832 F.3d 1318 (11th Cir. 2016).

³⁸ *Altman Contractors, Inc. v. Crum & Forster Specialty Ins. Co.*, 232 So. 3d 273 (Fla. 2017).

³⁹ *Altman Contractors, Inc. v. Crum & Forster Specialty Ins. Co.*, 880 F.3d 1300 (11th Cir. 2018).

⁴⁰ See *Houston Cas. Co. v. Swinerton Builders*, 2022 WL 523434 (D. Colo. Feb 22, 2022) (rejecting the insured’s argument that a right to repair demand letter constituted an al-

ternate dispute resolution proceeding, stating the demand letter didn't impose any legal obligations so that it could not constitute a "suit" under the plain meaning of the term); *Cincinnati Ins. Co. v. AMSCO Windows*, 593 Fed. Appx. 802 (10th Cir. 2014) (holding that under the Nevada right to repair statute, a statutory proceeding does not result in an adverse judgment, provides only limited consequences for noncompliance, and does not constitute a legal proceeding in which damages are claimed, nor an alternative dispute proceeding because the insurer did not consent).

⁴¹ *Lennar Corp.*, 413 S.W.3d at 750.

⁴² *Lennar Corp.*, 200 S.W.3d at 651.

⁴³ *Lennar Corp.*, 413 S.W.3d at 750.

⁴⁴ *American Home Assurance Co. v. Libbey-Owens Ford Co.*, 786 F.2d 22 (1st Cir. 1986).

⁴⁵ *Riley Stoker Corp. v. Fidelity & Guaranty Ins. Underwriters, Inc.* 26 F.3d 581 (5th Cir. 1994).

⁴⁶ *Id.* at 588.; see also *Insurance Co. of N. Am. v. Aberdeen Ins. Servs., Inc.*, 253 F.3d 878 (5th Cir. 2001) (applying Texas law, upholding coverage for liquidated damages assessed because of damage to pipeline caused by insured's subcontractor).

⁴⁷ *Cam-Sam Real Estate Holding, LLC v. Merchants Mut. Ins. Co.*, 2019 WL 2931648 (D.N.H. July 8, 2019).

⁴⁸ *King v. Dallas Fire Ins. Co.*, 85 S.W.3d 185 (Tex. 2002).

⁴⁹ Beware that pigeonholing each state's approach on coverage for defective work is not an exact science and often requires judgment calls to be made as to cases that should be included and where they should be categorized. In other words, there is always room for disagreement among coverage mavens (perhaps even the authors of this paper).

⁵⁰ *Kvaerner Metals Div. of Kvaerner U.S., Inc. v. Commercial Union Ins. Co.*, 908 A.2d 888 (Pa. 2006).

⁵¹ *Knoblich v. Erie Ins. Exchange*, 2024 WL 3649010 (Pa. Super Aug. 5, 2024).

⁵² *Kvaerner Metals*, 908 A.2d at 888.

⁵³ *U.S. Fire Ins. Co. v. Milton Co.*, 35 F. Supp. 2d 83 (D.D.C. 1998).

⁵⁴ *Employers Mut. Cas. Co. v. Bartile Roofs, Inc.*, 618 F.3d 1153 (10th Cir. 2010).

⁵⁵ *Group Builders, Inc. v. Admiral Ins. Co.*, 231 P3d 67 (Haw. App. 2010).

⁵⁶ *Lamar Homes, Inc.*, 242 S.W.3d at 1.

⁵⁷ *Id.* at 7.

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ *Id.* at 14 ("[W]e have not said that the subcontractor exception creates coverage; rather, it reinstates coverage that would otherwise be excluded under the your-work exclusion.").

⁶¹ *Id.* at 13 ("Therefore, any preconceived notion that a

CGL policy is only for tort liability must yield to the policy's actual language."); See also Ellen S. Pryor, *The Economic Loss Rule and Liability Insurance*, 48 ARIZ. L. REV. 905, 917 (2006).

⁶² *Lamar Homes*, 242 S.W.3d at 8.

⁶³ See *Travelers Indem. Co. of Am. v. Moore & Assocs., Inc.*, 216 S.W.3d 302, 308 (Tenn. 2007) ("If foreseeability is determined from the negligent completion of the project, then the negligent acts of the insured will almost never be 'accidents' because, by definition, negligence requires that damages be foreseeable.").

⁶⁴ *Acuity v. M/I Homes of Chicago, LLC*, 2023 IL 129087, 234 N.E.3d 97 (2023).

⁶⁵ *LCB, LLC v. Spectrum Brands, Inc.*, 2 N.W.3d 411 (Wis. Ct. App. 2023) and *Am. Family Mut. Ins. Co. v. Am. Girl, Inc.*, 673 N.W.2d 65, 78 (Wis. 2004).

⁶⁶ *Architex Ass'n, Inc. v. Scottsdale Ins. Co.*, 27 So. 3d 1148 (Miss. 2010).

⁶⁷ *Auto Owners Ins. Co., Inc. v. Newman*, 684 S.E.2d 541, 544–45 (S.C. 2009).

⁶⁸ *Travelers Indem. Co. of Am. v. Moore & Assocs., Inc.*, 216 S.W.3d 302, 308 (Tenn. 2007).

⁶⁹ *Lee Builders, Inc. v. Farm Bureau Mut. Ins. Co.*, 137 P.3d 486, 495 (Kan. 2006).

⁷⁰ *Sheehan Constr. Co., Inc. v. Cont'l Cas. Co.*, 935 N.E.2d 160 (Ind. 2010).

⁷¹ *Fejes v. Alaska Ins. Co.*, 984 P.2d 519 (Alaska 1999) (1973 policy form).

⁷² *Broadmoor Anderson v. Nat'l Union Fire Ins. Co.*, 912 So. 2d 400 (La. App. 2d Cir. 2005). *cert. denied*, 925 So. 2d 1239 (La. 2006).

⁷³ *Boothbay Harbor Shipyard, LLC v. North Am. Specialty Ins. Co.*, 2012 WL 3779207, 2012 U.S. Dist. LEXIS 123525 (D. Me. Aug. 30, 2012).

⁷⁴ *Skanska USA Bldg., Inc. v. M.A.P. Mech. Contractors, Inc.*, 505 Mich. 368, 952 N.W.2d 402 (2020).

⁷⁵ *Wanzek Constr., Inc. v. Employers Ins. of Wausau*, 679 N.W.2d 322 (Minn. 2004).

⁷⁶ *Employers Mut. Cas. Co. v. Fisher Builders, Inc.*, 371 P.3d 375 (Mont. 2016).

⁷⁷ *Big-D Constr. Corp. v. Take It for Granite Too*, 917 F. Supp. 2d 1096 (D. Nev. 2013).

⁷⁸ *K & L Homes, Inc. v. American Family Mut. Ins. Co.*, 829 N.W.2d 724 (N.D. 2013). But see *Pavlicev v. American Steel Sys., Inc.*, 970 N.W.2d 171 (N.D. 2022).

⁷⁹ *Twigg v. Admiral Ins. Co.*, 373 Or. 445, 568 P.3d 156 (Or. 2025).

⁸⁰ *Owners Ins. Co. v. Tibke Constr., Inc.*, 901 N.W.2d 80 (S.D. 2017).

⁸¹ *Fine Paints of Europe, Inc. v. Acadia Ins. Co.*, 2009 WL 819466, 2009 U.S. Dist. LEXIS 24188 (D. Vt. Mar. 24, 2009).

⁸² *Travelers Prop. Cas. Co. of Am. v. Northwest Pipe*

Co., 2017 WL 2687652, 2017 U.S. Dist. LEXIS 96643 (W.D. Wash. June 22, 2017).

⁸³ *State ex rel. Nationwide Mut. Ins. Co. v. Wilson*, 778 S.E.2d 677 (W. Va. 2015).

⁸⁴ Ark. Stat. § 23–79–155.

⁸⁵ *U.S. Fire Ins. Co. v. J.S.U.B.*, 979 So. 2d 871, 877–80 (Fla. 2007).

⁸⁶ *Id.* at 883.

⁸⁷ *Id.* at 886–87.

⁸⁸ *Id.* at 887–88.

⁸⁹ *State Farm Fire & Cas. Co. v. CTC Dev. Corp.*, 720 So. 2d 1072 (Fla. 1998).

⁹⁰ *Owners Ins. Co. v. Jim Carr Homebuilder, LLC*, 157 So. 3d 148 (Ala. 2014); *Lennar Corp. v. Auto-Owners Ins. Co.*, 214 Ariz. 255, 151 P.3d 538 (App. 2007); *Regional Steel Corp. v. Liberty Surplus Ins. Corp.*, 226 Cal. App. 4th 1377, 173 Cal. Rptr. 3d 91 (2014); *Greystone Constr., Inc. v. National Fire & Marine Ins. Co.*, 661 F.3d 1272 (10th Cir. 2011), *but see* C.R.S.A. § 13–20–808 (providing that with respect to CGL policies in existence as of, or issued on or after, May 21, 2010, faulty workmanship by statute constitutes an “occurrence.” The statute further directs state courts to “presume that the work of a construction professional that results in property damage, including damage to the work itself or other work, is an accident unless the property damage is intended and expected by the insured.” Nevertheless, the statute does not require coverage for damage to an insured’s own work unless otherwise provided in the insurance policy and does not create insurance coverage that is not included in the policy); *Capstone Bldg. Corp. v. American Motorists Ins. Co.*, 67 A.3d 961 (Conn. 2013); *Taylor Morrison Servs., Inc. v. HDI-Gerling Am. Ins. Co.*, 746 S.E.2d 587 (Ga. 2013); *National Sur. Corp. v. Westlake Investments, LLC*, 880 N.W.2d 724 (Iowa 2016); *Pennsylvania Nat’l Mut. Cas. Ins. Co. v. Alliance Roofing & Sheet Metal, Inc.*, 2013 WL 1120587, 2013 U.S. Dist. LEXIS 38567 (D. Md. Mar. 14, 2013); *Cypress Point Condo. Ass’n, Inc. v. Adria Towers, L.L.C.*, 143 A.3d 273 (N.J. 2016); *Pulte Homes of N.M., Inc. v. Indiana Lumbermens Ins. Co.*, 367 P.3d 869 (N.M. Ct. App. 2015); *Fountaincourt Homeowners’ Ass’n v. Fountaincourt Dev., LLC*, 360 Or. 341, 380 P.3d 916 (2016); *Furey Roofing & Constr. Co., Inc. v. Employers Mut. Cas. Ins. Co.*, 2010 WL 422253, 2010 R.I. Super. LEXIS 24 (R.I. Super. Feb. 1, 2010); *Crossmann Communities of N.C., Inc. v. Harleysville Mut. Ins. Co.*, 395 S.C. 40, 717 S.E.2d 589 (2011), *but see* So. Car. Stat. § 38–61–70 (passed in 2011, stating the same principle—that property damage to other work resulting from defective workmanship, but not the defective workmanship itself, constitutes an occurrence under a CGL policy); *Travelers Indem. Co. of Am. v. Moore & Assocs., Inc.*, 216 S.W.3d 302 (Tenn. 2007); *Cincinnati Ins. Co. v. AMSCO Windows*, 593 Fed. Appx. 802 (10th Cir. 2014); *Nautilus Ins. Co. v. Strongwell Corp.*, 968 F. Supp. 2d 807 (W.D. Va. 2013).

⁹¹ *McLaughlin v. Gaslight Pointe Condo. Ass’n, LTD*,

2024 WI App 30, 412 Wis. 2d 140, 8 N.W.3d 115.

⁹² *Id.* at 124.

⁹³ *Id.* at 125.

⁹⁴ *Acuity v. M/I Homes of Chicago, LLC*, 2023 IL 129087, reh’g denied (Jan. 22, 2024).

⁹⁵ *Lexicon, Inc. v. ACE Am. Ins. Co.*, 634 F.3d 423 (8th Cir. 2011).

⁹⁶ *Essex Ins. Co. v. Holder*, 372 Ark. 535, 261 S.W.3d 456 (2008).

⁹⁷ *Id.* at 460.

⁹⁸ *Lessard v. Havens & Sons, Inc.*, 241 N.E.3d 744 (Mass. Ct. App. 2024).

⁹⁹ *Martin/Elias Props., LLC v. Acuity*, 544 S.W.3d 639 (Ky. 2018) *citing Cincinnati Ins. Co. v. Motorists Mut. Ins. Co.*, 306 S.W.3d 69 (Ky. 2010); *General Cas. Co. v. Five Star Bldg. Corp.*, 2013 WL 5297095, 2013 U.S. Dist. LEXIS 38567 (D. Mass. Sept. 19, 2013); *American Family Mut. Ins. Co. v. Mid-American Grain Distributors, LLC*, 958 F.3d 748 (8th Cir. 2020) (applying Missouri law); *Auto-Owners Ins. Co. v. Home Pride Cos.*, 268 Neb. 528, 684 N.W.2d 571 (2004); *Fletch’s Sandblasting & Painting, Inc. v. Colony Ins. Co.*, 2017 WL 2455040, 2017 D.N.H. 097 (2017); *Eurotech Constr. Corp. v. QBE Ins. Corp.*, 26 N.Y.S.3d 703 (N.Y. App. Div. 2016), *but see Black & Veatch Corp. v. Aspen Ins. (UK) Ltd.*, 882 F.3d 952 (10th Cir. 2018) (applying New York law and predicting that New York would follow the trend as to broadening coverage for property damage arising out of construction defects); *Harleysville Mut. Ins. Co. v. Hartford Cas. Ins. Co.*, 90 F. Supp. 3d 526 (E.D.N.C. Feb. 27, 2015).

¹⁰⁰ *Westfield Ins. Co., Inc. v. Miranda & Hardt Contracting & Building Servs., LLC*, 2015 WL 1477970, 2015 Del. Super. LEXIS 160 (Del. Super. Ct. Mar. 30, 2015).

¹⁰¹ *Group Builders v. Admiral Ins.*, 231 P.3d 67 (Haw. Ct. App. 2010).

¹⁰² Hawaii Stat. § 431:217.

¹⁰³ *Nautilus Ins. Co. v. 3 Builders, Inc.*, 955 F. Supp. 2d 1121 (D. Haw. 2013).

¹⁰⁴ *Burlington Ins. Co. v. Oceanic Design & Constr., Inc.*, 383 F.3d 940 (9th Cir. 2004).

¹⁰⁵ *See Westfield Ins. Co. v. Custom Agri Sys., Inc.*, 979 N.E.2d 269 (Ohio 2012) (claims of defective work against contractor and subcontractor that constructed a defective grain bin were not claims for property damage caused by an occurrence); *Ohio Northern University v. Charles Constr. Servs. Inc.*, 120 N.E.3d 762 (Ohio 2020) (extensive water damage resulting from a subcontractor’s faulty work was not fortuitous and, therefore, did not meet the definition of an occurrence, relying on *Custom Agri* for the principle that a CGL policy does not insure the insured’s work itself but does insure consequential damages from that work). The *Ohio Northern University* opinion addressed new construction, however, so the entire building was the insured general contractor’s own work, and it is unclear

whether the law allows coverage for resulting damage.

¹⁰⁶ *Compare North Star Mut. Ins. Co. v. Rose*, 27 F. Supp. 3d 1250 (E.D. Okla. 2014) (upholding coverage where property damage was to third party property), with *American Modern Select Ins. Co. v. Crum*, 2008 WL 4936703, 2008 U.S. Dist. LEXIS 93748 (N.D. Okla. Nov. 17, 2008) (defective work on residence did not constitute an occurrence, even if the resulting structural damage was unexpected, unforeseen, or unintended by the insured).

¹⁰⁷ *Soule v. Woodward Design + Build, LLC*, 382 So. 3d 1052 (La. Ct. App. 2023).

¹⁰⁸ *See Don's Bldg. Supply, Inc. v. OneBeacon Ins. Co.*, 267 S.W.3d 20, 27–28 (Tex. 2008).

¹⁰⁹ PHILIP L. BRUNER & PATRICK J. O'CONNOR JR., *BRUNER & O'CONNOR ON CONSTRUCTION LAW* § 11.182 (2010); see also 2 JEFFREY W. STEMPER, *STEMPER ON INSURANCE CONTRACTS* § 14.09[B] (3d ed. 2005 & Supp. 2009) (“The manifestation theory is less widely embraced, at least for liability insurance (although it is the norm for determining which first party property policy is triggered”).

¹¹⁰ *See Gelman Sciences, Inc. v. Fid. & Cas. Co. of N.Y.*, 572 N.W.2d 627, 623 (1998) (“The manifestation trigger simply is not supported by the policy language.”).

¹¹¹ *See, e.g., Guar. Nat'l Ins. Co. v. Azrock Indus., Inc.*, 211 F.3d 239, 243–248 (5th Cir. 2000) (discussing various trigger theories and concluding that different trigger theories would apply to property damage and bodily injury).

¹¹² *American Employer's Ins. Co. v. Pinkard Construction Co.*, 806 P.2d 954 (Colo. Ct. App. 1990).

¹¹³ *Don's Bldg. Supply, Inc. v. OneBeacon Ins. Co.*, 267 S.W.3d 20, 29 (Tex. 2008).

¹¹⁴ *EnergyNorth Nat. Gas, Inc. v. Underwriters at Lloyd's*, 848 A.2d 715, 718 (N.H. 2004) (recognizing little difference between injury-in-fact and exposure theories when contamination begins almost immediately after release of hazardous materials).

¹¹⁵ *Don's Bldg. Supply, Inc.*, 267 S.W.3d at 30.

¹¹⁶ *Id.*; *Carithers v. Mid-Continent Cas. Co.*, 782 F.3d 1240 (11th Cir. 2015); *Wooddale Builders, Inc. v. Maryland Cas. Co.*, 722 N.W.2d 283 (Minn. 2006); *Transcon Ins. Co. v. W.G. Samuels Co.*, 370 F.3d 755, 758 (8th Cir. 2004) (applying Kansas law); *Hoang v. Assurance Co. of Am.*, 149 P.3d 798, 800–01. (Colo. 2007).

¹¹⁷ *Keene Corp. v. Insurance Company of North America*, 667 F.2d 1034 (D.C. Cir. 1981), *cert. denied*, 455 U.S. 1007, 102 S. Ct. 1644 (1982).

¹¹⁸ *See Air Master & Cooling, Inc. v. Selective Ins. Co. of Am.*, 171 A.3d 214 (N.J. Super. App. Div. 2017); *Century Indem. Co. v. Golden Hills Builders, Inc.*, 348 S.E.2d 344 (S.C. 2002); *Gruol Constr. Co., Inc. v. Ins. Co. of N. Am.*, 524 P.2d 427 (Wash. Ct. App. 1974). See also *Joe Harden Builders, Inc. v. Aetna Cas. & Sur. Co.*, 486 S.E.2d 89 (S.C. 1997) (applying modified approach, including injury-in-fact and continuous

triggers).

¹¹⁹ *Keene Corp.*, 667 F.2d at 1034.

¹²⁰ *Armstrong World Indus., Inc. v. Aetna Cas. & Sur. Co.*, 45 Cal. App. 4th 1, 52 Cal. Rptr. 2d 690 (1996).

¹²¹ *Gruol Constr. Co. v. Insurance Co. of N. Am.*, 11 Wash. App. 632, 524 P.2d 427 (1974).

¹²² *Lennar Corp.*, 413 S.W.3d at 750.

¹²³ *Am. Physicians Ins. Exchange v. Garcia*, 876 S.W.2d 842 (Tex. 1994).

¹²⁴ *Lennar Corp.*, 413 S.W.3d at 758.

¹²⁵ *State v. Continental Ins. Co.*, 281 P.3d 1000 (Cal. 2012).

¹²⁶ *Colony Ins. Co. v. First Mercury Ins. Co.*, 88 F.4th 1100 (5th Cir. 2023).

¹²⁷ *Insurance Co. of N. Am. v. Forty-Eight Insulations, Inc.*, 633 F.2d 1212 (6th Cir. 1980).

¹²⁸ *Wooddale Builders, Inc. v. Maryland Cas. Co.*, 722 N.W.2d 283 (Minn. 2006).

¹²⁹ *Public Serv. Co. v. Wallis & Cos.*, 986 P.2d 924 (Colo. 1999).

¹³⁰ *Hoang v. Assurance Co. of America*, 149 P.3d 798 (Colo. 2007).

¹³¹ *Pella Corp. v. Liberty Mut. Ins. Co.*, 244 F. Supp. 3d 931 (S.D. Iowa 2017).

¹³² The following illustrate the complexities of these clauses: *In re Viking Pump, Inc.*, 52 N.E.3d 1144 (N.Y. 2016); *Olin Corp. v. OneBeacon Am. Ins. Co.*, 864 F.3d 130 (2d Cir. 2017).

¹³³ *Crossman Communities of N.C., Inc. v. Harleysville Mut. Ins. Co.*, 717 S.E.2d 589 (S.C. 2011).

¹³⁴ *Penn. Nat'l Mut. Cas. Ins. Co. v. Zonko Bldrs, Inc.*, 2023 WL 11199702 (D. Del. 2023).

¹³⁵ *Id.* at *1.

¹³⁶ *Hauenstein v. St. Paul-Mercury Indem. Co.*, 65 N.W.2d 122 (Minn. 1954).

¹³⁷ *Id.* at 125.

¹³⁸ *Traveler's Ins. Co. v. Eljer Mfg., Inc.*, 757 N.E.2d 481 (Ill. 2001); *Lennar Corp. v. Great Am. Ins. Co.*, 200 S.W.3d 651 (Tex. App.—14th Dist. 2006), *pet. denied. Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 242 S.W.3d 1, 10 (Tex. 2007) (“These allegations of cracking sheetrock and stone veneer are allegations of ‘physical injury’ to ‘tangible property.’”); *Fidelity & Deposit Co. of Md. v. Hartford Cas. Ins. Co.*, 189 F. Supp. 2d 1171 (D. Kan. 2002); *Am. Family Mut. Ins. Co. v. Am. Girl, Inc.*, 673 N.W.2d 65, 75 (Wis. 2004) (“The sinking, buckling, and cracking of the warehouse as a result of the soil settlement qualifies as ‘physical injury to tangible property.’”); *Amerisure Mutual Ins. Co. v. McMillin Texas Homes*, 2022 WL 686727 (W.D. Tex. Mar. 3, 2022) (provides an extended discussion of property damage arising out of water infiltration under Texas law sufficient to trigger the duty to defend.)

¹³⁹ *TIG Ins. Co. v. Woodsboro Farmers Coop.*, 2024 WL

4247287 (5th Cir. Sept. 20, 2024).

¹⁴⁰ *Id.* at 725, citing *Lamar Homes v. Mid-Continent*, 242 S.W.3d 1 (Tex. 2007).

¹⁴¹ *Lamar Homes*, 242 S.W.3d at 1.

¹⁴² *See supra* n. 138.

¹⁴³ *Mid-Continent Cas. Co. v. Vibrant Builders, LLC*, 2024 WL 3891362 (N.D. Tex. Aug. 21, 2024).

¹⁴⁴ *Id.* at *5.

¹⁴⁵ *Auto-Owners Ins. Co. v. Pozzi Window Co.*, 984 So. 2d 1241 (Fla. 2008).

¹⁴⁶ *F&H Constr. v. ITT Hartford Ins. Co. of Midwest*, 12 Cal. Rptr. 3d 896 (Cal. 2004) (“[T]he prevailing view is that the incorporation of a defective component or product into a larger structure does not constitute property damage unless and until the defective component causes physical injury to tangible property in at least some other part of the system.”); *Esicorp, Inc. v. Liberty Mut. Ins. Co.*, 266 F.3d 859, 862 (8th Cir. 2001) (holding that defective steel pipe sections welded into pipe system did not constitute physical injury to tangible property, the pipe system); *Nat’l Union Fire Ins. Co. of Pa. v. Terra Indus., Inc.*, 216 F. Supp. 2d 899, 917 (N.D. Iowa 2002) (holding that carbonated beverages suffered property damage as a result of introduction of carbon dioxide containing benzene); *see also Tweet/Garot-August Winter, LLC v. Liberty Mut. Fire Ins. Co.*, 2007 WL 445988 (E.D. Wis. Feb. 07, 2007) (collecting cases).

¹⁴⁷ *U.S. Metals, Inc. v. Liberty Mut. Group, Inc.*, 490 S.W.3d 20 (Tex. 2015).

¹⁴⁸ *Id.* at 27.

¹⁴⁹ *Acuity v. M/I Homes of Chicago, LLC*, 2023 IL 129087, 234 N.E.3d 97 (2023).

¹⁵⁰ *St. Paul Guardian Ins. Co. v. Walsh Constr. Co.*, 99 F.4th 1035 (7th Cir. 2024).

¹⁵¹ *Id.* at 1042.

¹⁵² *Id.*

¹⁵³ *See Guerin Contractors, Inc. v. Bituminous Cas. Corp.*, 636 S.W.2d 638, 641 (Ark. Ct. App. 1982); *Gibson & Assoc., Inc. v. Home Ins. Co.*, 966 F. Supp. 2d 468, 477 (N.D. Tex. 1997).

¹⁵⁴ *See, e.g., Anthem Electronics, Inc. v. Pac. Employers Ins. Co.*, 302 F.3d 1049, 1057 (9th Cir. 2002).

¹⁵⁵ *See, e.g., Hartzell Indus., Inc. v. Fed. Ins. Co.*, 168 F. Supp. 2d 789, 795 (S.D. Ohio 2001).

¹⁵⁶ *Fid. & Deposit Co. v. Hartford Cas. Ins. Co.*, 189 F. Supp. 2d 1212, 1220 (D. Kan. 2002).

¹⁵⁷ *Id.* at 1220.

¹⁵⁸ *See, e.g., R.N. Thompson & Assocs., Inc. v. Monroe Guar. Ins. Co.*, 686 N.E.2d 160, 162–64 (Ind. Ct. App. 1997); *Acadia Ins. Co. v. Peerless Ins. Co.*, 2010 WL 198463 (D. Mass. Jan 21, 2010) (“[F]or purposes of a CGL policy, covered ‘property damage’ is alleged only when property other than the insured’s work product has suffered harm.”); *U.S. Fire*

Ins. Co. v. J.S.U.B., 979 So. 2d 871, 889 (Fla. 2007) (“[O]ther courts have also recognized that there is a difference between a claim for the costs of repairing or removing the defective work, which is not a claim for ‘property damage,’ and a claim for the costs of repairing damage caused by the defective work, which is a claim for ‘property damage.’”).

¹⁵⁹ *Barrs v. Auto-Owners Ins. Co.*, 2024 WL 3673089 (11th Cir. August 6, 2024).

¹⁶⁰ *Id.* at *3–5.

¹⁶¹ *American Family Mutual Ins. Co. v. American Girl, Inc.*, 673 N.W.2d 65, 80–81 (2004).

¹⁶² *Id.*; *see also Federated Mut. Ins. Co. v. Grapevine Excavation, Inc.*, 197 F.3d 720, 726 (5th Cir. 1999) (exclusion denies coverage when the insured assumes responsibility for the conduct of a third party and not its own conduct); *Olympic, Inc. v. Providence Wash. Ins. Co. of Alaska*, 648 P.2d 1008, 1011 (Alaska 1982) (liability assumed by insured in a contract refers to liability incurred when one promises to indemnify or hold harmless another, and it does not refer to liability that results from breach of contract).

¹⁶³ *Allied Prop. & Cas. Ins. Co. v. Metro N. Condo. Assoc.*, 850 F.3d 844 (7th Cir. 2017); *Murphy Oil Corp. v. Liberty Mut. Fire Ins. Co.*, 955 F.3d 1110 (8th Cir. 2020); *North Star Mut. Ins. Co. v. Rose*, 27 F. Supp. 3d 1250 (E.D. Okla. 2014).

¹⁶⁴ *Gilbert Tex. Constr., L.P. v. Underwriters at Lloyd’s London*, 327 S.W.3d 118 (Tex. 2010).

¹⁶⁵ *Id.* at 127.

¹⁶⁶ *Lamar Homes*, 242 S.W.3d at 1.

¹⁶⁷ *Gilbert*, S.W.3d at 127.

¹⁶⁸ *Id.*

¹⁶⁹ *Ewing Constr. Co., Inc. v. Amerisure Ins. Co.*, 420 S.W.3d 30 (Tex. 2014).

¹⁷⁰ *Ewing Constr. Co., Inc. v. Amerisure Ins. Co.*, 684 F.3d 512 (5th Cir. 2012).

¹⁷¹ *Ewing Constr. Co., Inc. v. Amerisure Ins. Co.*, 690 F.3d 628 (5th Cir. 2012).

¹⁷² *Ewing Constr. Co., Inc.* S.W.3d at 37–38 (citing *American Family Mut. Ins. Co. v. American Girl, Inc.*, 268 N.W.2d 65 (Wis. 2004)).

¹⁷³ *Ewing Constr. Co., Inc.* S.W.3d at 37–38.

¹⁷⁴ *Crownover v. Mid-Continent Cas. Co.*, 772 F.3d 197 (5th Cir. 2014).

¹⁷⁵ *Siplast, Inc. v. Employers Mut. Cas. Co.*, 23 F.4th 486, 498 (5th Cir. 2022).

¹⁷⁶ B.R. OSTRAGER AND T.R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES, § 10.02[b] (20th ed. 2021).

¹⁷⁷ *Cam-Sam Real Estate Holding, LLC v. Merchants Mut. Ins. Co.*, 2019 WL 2931648 D.N.H. (July 8, 2019); *See also Finger Oil & Gas, Inc. v. Mid-Continent Cas. Co.*, 2022 WL 1241972, 2022 U.S. Dist. LEXIS 76639 (W.D. Tex. April 27, 2022); *Dryden Oil Co. of New England, Inc. v. Travelers Indem. Co.*, 91 F.3d 278, 284 (1st Cir. 1995) (recognizing the

salutary effect of denying liability coverage to an insured for its owned, occupied, or rented property).

¹⁷⁸ *State Farm Fire & Casualty Co. v. English Cove Ass'n, Inc.*, 88 P.3d 986 (Wash. Ct. App. 2004); see also *Cogswell Farm Condo. Ass'n v. Tower Group, Inc.*, 167 N.H. 245, 110 A.3d 822 (2015).

¹⁷⁹ *State Farm Fire & Casualty Co.*, 88 P.3d 986 (Wash. Ct. App. 2004) at 367.

¹⁸⁰ See, e.g., *Borden, Inc. v. Affiliated FM Ins. Co.*, 682 F. Supp. 927 (S.D. Ohio 1987), *aff'd*, 865 F.2d 1267 (6th Cir. 1989), *cert. denied*, 493 U.S. 817 (1989).

¹⁸¹ *Maryland Casualty Co. v. Reeder*, 270 Cal. Rptr. 719 (Cal. Ct. App. 1990).

¹⁸² *Estrin Constr. Co., Inc. v. Aetna Cas. & Surety Co.*, 612 S.W.2d 413 (Mo. Ct. App. 1981).

¹⁸³ *Id.* at 429.

¹⁸⁴ *Houston Building Servs., Inc. v. American General Fire & Cas. Co.*, 799 S.W.2d 308 (Tex. App.—Houston [1st Dist.] 1990, writ denied) (finding that doors and frames in an office building were annexed to the building and adapted for a specific use of the property and were therefore real property). See also *Crane Operators, Inc. v. Fidelity Excess & Surplus Ins. Co., Inc.*, 818 So. 2d 1030 (La. Ct. App. 2002) (finding that a crane barge damaged by a crane boom was personal property because the crane barge was movable within the meaning of the care, custody, or control exclusion); *National Union Fire Ins. Co. of Pittsburgh v. Structural Sys. Tech., Inc.*, 964 F.2d 759 (8th Cir. 1992) (rejecting the insurer's contention that the care, custody, or control exclusion applied to a radio tower that collapsed, holding that the tower constituted real property and the exclusion applied only to personal property, so the exclusion did not eliminate coverage).

¹⁸⁵ *Barrs v. Auto-Owners Ins. Co.*, 2024 WL 3673089 (11th Cir. August 6, 2024).

¹⁸⁶ *Id.* at *4.

¹⁸⁷ *Id.* at *4–5.

¹⁸⁸ *Id.* at *5.

¹⁸⁹ See generally *Satterfield and Pontikes Constr., Inc. v. United States Fire Ins. Co.*, 989 F.3d 574 (5th Cir. 2018).

¹⁹⁰ *CU Lloyd's of Texas v. Main Street Homes, Inc.*, 79 S.W.3d 687 (Tex. App.—Austin 2002, no pet.).

¹⁹¹ *Id.* at 697.

¹⁹² *Mid-Continent Casualty Co. v. JHP Development, Inc.*, 557 F.3d 207 (5th Cir. 2009).

¹⁹³ *Id.* at 213–14.

¹⁹⁴ ISO CIRCULAR GENERAL LIABILITY GL79-12 (Jan. 29, 1979).

¹⁹⁵ *Mid-Continent Cas. Co.*, 557 F.3d at 207.

¹⁹⁶ *Id.* at 215.

¹⁹⁷ *Gore Design Completion, Ltd. v. Hartford Fire Ins. Co.*, 538 F.3d 365 (5th Cir. 2008).

¹⁹⁸ *Id.* at 371–72.

¹⁹⁹ *Mid-Continent Cas. Co. v. Vibrant Builders, LLC*, 2024 WL 3891362 (N.D. Tex. Aug. 21, 2024).

²⁰⁰ *Id.* at *8–9 (citing *Mid-Continent Cas. Co. v. JHP Dev., Inc.*, 557 F.3d 207 (5th Cir. 2009)).

²⁰¹ *Mid-Continent Cas. Co. v. Vibrant Builders, LLC*, 2024 WL 3891362 at *8.

²⁰² *Amerisure Mutual Ins. Co. v. McMillin Texas Homes*, 2022 WL 686727 (W.D. Tex. Mar. 3, 2022).

²⁰³ *Mid-Continent Casualty Co.*, 557 F.3d at 207.

²⁰⁴ *Amerisure Mutual Insurance Co.*, 2022 WL 686727 at *9; see also *Travelers Lloyds Ins. Co. v. Cruz Contracting of Texas, LLC*, 2017 WL 5202891, 2017 U.S. Dist. LEXIS 215264 (W.D. Tex. Sep. 7, 2017) (citing *Mid-Continent v. JHP*, the court determined the exclusion did not bar coverage for damage to other work, and only applied to work upon which the insured was currently performing operations at the time of the property damage).

²⁰⁵ *Transportation Ins. Co. v. Piedmont Construction Group, LLC*, 686 S.E.2d 824 (Ga. Ct. App. 2009).

²⁰⁶ *Id.* at 827.

²⁰⁷ *Suez Treatment Sols., Inc. v. ACE Am. Ins. Co.*, 2022 WL 954601, 2022 U.S. Dist. LEXIS 59044 (S.D.N.Y. Mar. 30, 2022).

²⁰⁸ *Id.* at *13.

²⁰⁹ *Southern-Owners Ins. Co. v. MAC Contractors, Inc.*, 2024 WL 1573685 (11th Cir. Apr. 11, 2024).

²¹⁰ *Id.* at *3.

²¹¹ *United Specialty Ins. Co. v. Dorn Homes Inc.*, 2020 WL 4464400 (D. Ariz. Aug. 4, 2020).

²¹² *Id.* at *11.

²¹³ JEFFREY WOODWARD AND HENRY STORY, COMMERCIAL LIABILITY INSURANCE (IRMI 2000-2024).

²¹⁴ JEFFREY W. STEMPEL, STEMPEL ON INSURANCE CONTRACTS § 14.13(D), at 14-224.8 (3d ed. supp. 2007).

²¹⁵ Jeffrey P. Aiken & Tamara Hayes O'Brien, *Contractor Coverage for Construction Claims Under CGL Policies: The Basics and Beyond*, 44 TORT TRIAL & INS. PRAC. L. J. 993, 1010 (Spring/Summer 2009).

²¹⁶ *Lamar Homes*, 242 S.W.3d at 1.

²¹⁷ *United States Fire Ins. Co. v. J.S.U.B., Inc.*, 979 So. 2d 871 (Fla. 2007).

²¹⁸ *Travelers Indemnity Co. America v. Moore & Associates, Inc.*, 216 S.W.3d 308, 310 (Tenn. 2007).

²¹⁹ *Architex Ass'n, Inc. v. Scottsdale Ins. Co.*, 27 So. 3d 1148 (Miss. 2010).

²²⁰ *American Family Mut. Ins. Co. v. American Girl, Inc.*, 673 N.W.2d 65, 83 (Wis. 2004).

²²¹ *Lee Builders, Inc. v. Farm Bureau Mut. Ins. Co.*, 137 P.3d 486, 495 (Kan. 2006).

²²² *Auto Owners Ins. Co. v. Newman*, 684 S.E.2d 541 (S.C. 2009), *overruled on other grounds*.

²²³ *Crossmann Communities of N.C. v. Harleysville Mut.*

Ins. Co., 2011 WL 93716 (S.C. Jan. 7, 2011).

²²⁴ See, e.g., *United Fire Lloyds v. JD Kunz Concrete Contractor, Inc.*, 2023 WL 7171475 (Tex. App.—El Paso, Oct. 31, 2023, pet. filed) (assessing the sufficiency of the evidence to support performance of work by subcontractors); *National Sur. Corp. v. Westlake Investments, LLC*, 880 N.W.2d 724 (Iowa 2016); *Cypress Point Condo. Ass’n, Inc. v. Adria Towers, LLC*, 226 N.J. 403, 143 A.3d 273 (2016); *Western Nat’l Mut. Ins. Co. v. Gateway Bldg. Sys., Inc.*, 887 N.W.2d 887 (S.D. 2016).

²²⁵ *Kvaerner Metals v. Commercial Union Ins. Co.*, 908 A.2d 888 (Pa. 2006).

²²⁶ See also *William C. Vick Construction Co. v. Pennsylvania National Mutual Casualty Insurance Co.*, 52 F. Supp. 2d 569 (E.D. N.C. 1999), *aff’d*, 213 F.3d 634 (4th Cir. 2000) (seminal case decided under the 1973 broad form property damage endorsement that coverage for the defective workmanship of the insured’s subcontractor was nevertheless excluded based upon a business risk rationale); *Lexicon, Inc. v. ACE American Insurance Co.*, 634 F.3d 423, (8th Cir. 2011) (applying Arkansas law) (finding that collapse of a silo arising out of defective welding by a subcontractor was not an occurrence under Arkansas law despite subcontractor exception).

²²⁷ As to an analysis of the exclusion as applied to operations versus completed operations, see *Amerisure Mut. Ins. Co. v. McMillin Texas Homes*, 2022 WL 686727 (W.D. Tex. Mar. 3, 2022).

²²⁸ For example, in *Com. Chem. Prods., Inc. v. Jake’s Towing, L.L.C.*, 390 So.3d 421 (La. Ct. App. 2024).

²²⁹ *Id.* at 426.

²³⁰ *American Home Assur. Co. v. Cat Tech, LLC*, 660 F.3d 216 (5th Cir. Tex. 2011).

²³¹ *Id.* at 224.

²³² *Lamar Homes, Inc.*, 242 S.W.3d at 12.

²³³ See *Wm. C. Vick Const. Co. v. Pennsylvania Nat’l Mut. Cas. Ins. Co.*, 52 F.Supp.2d 569 (E.D.N.C. 1999) (in the context of a claim causing damage to a building through a leaky roof installed by a subcontractor, the court ignored the Broad Form Property Damage Endorsement, concluding that the better reasoned cases held that a building, or a building addition, falls within the meaning of the term “project” as used in CGL policies, and therefore was excluded under the 1973 products exclusion).

²³⁴ Insurance Services Office, Inc., *ISO Commercial Lines Policy and Ratings Simplification Project: Introduction and Review-Commercial General Liability* (1985).

²³⁵ *United Fire Lloyds v. JD Kunz Concrete Contractor, Inc.*, No. 08-23-00047-CV, 2023 WL 7171475 (Tex. App.—El Paso Oct. 31, 2023, pet. denied).

²³⁶ *CU Lloyd’s of Tex. v. Main Street Homes, Inc.*, 79 S.W.3d 687, 690 (Tex. App.—Austin 2002, no pet.).

²³⁷ *Wanzek Construction, Inc. v. Employers Ins. of Wausau*, 679 N.W.2d 322 (Minn. 2004).

²³⁸ *United Specialty Ins. Co. v. Dorn Homes Inc.*, 2020

WL 4464400 (D. Ariz. Aug. 4, 2020).

²³⁹ *Id.* at *11.

²⁴⁰ *Building Specialties, Inc. v. Liberty Mut. Fire Ins. Co.*, 712 F.Supp.2d 628 (S.D. Tex. 2010).

²⁴¹ *Id.* at 647. See also *Scottsdale Insurance Company v. Tri-State Insurance Company of Minnesota*, 302 F. Supp.2d 1100 (D.N.D. Feb. 20, 2004) (holding that the real property exception to the your product exclusion applied to prefabricated modular units manufactured by the insureds after the units were assembled and fixed to the foundation for incorporation into motel).

²⁴² *Admiral Ins. Co. v. Little Big Inch Pipeline Co.*, 523 F. Supp. 2d 524 (W.D. Tex. 2007).

²⁴³ *Corn Plus Co-Op v. Continental Cas. Co.*, 516 F.3d 674 (8th Cir. 2008).

²⁴⁴ *Standard Fire Ins. Co. v. Chester-O’Donley & Assoc., Inc.*, 972 S.W.2d 1 (Tenn. Ct. App. 1998).

²⁴⁵ *Id.*

²⁴⁶ See *Federated Mut. Ins. Co. v. Grapevine Excavation, Inc.*, 197 F.3d 720 (5th Cir. 1999) (insured excavation contractor’s work damaged a parking lot, and the proposed repair was to overlay the parking lot with additional asphalt, rather than remove or repair the select fill installed by the subcontractor, holding that the parking lot did not constitute impaired property because there was no suggestion that the damage to the surface of the parking lot could be restored by the repair, replacement, adjustment, or removal of the select fill installed by the excavation subcontractor). But see *North Star Mut. Ins. Co. v. Rose*, 27 F.Supp.3d 1250 (E.D. Okla. 2014) (finding that the impaired property exclusion did not apply to claims brought by the homeowners against the insured HVAC installer because the defective work could not be repaired or replaced without causing physical injury to other property, particularly because there was a potential for damage to property surrounding the HVAC installation due to removing subflooring to reach the ducts in order to repair or replace the insured’s work).

²⁴⁷ *U.S. Metals, Inc. v. Liberty Mutual Group, Inc.*, 490 S.W.3d 20 (Tex. 2015).

²⁴⁸ *Id.* at 28.

²⁴⁹ *Id.*

²⁵⁰ *Amerisure Mut. Ins. Co.*, 2022 WL 686727 at *1.

²⁵¹ *Travelers Lloyds Ins. Co. v. Cruz Constr. of Tex., LLC*, 2017 WL 5202891, 2017 U.S. Dist. LEXIS 215264 (W.D. Tex. Sep. 7, 2017).

²⁵² *Id.* at *5 (citing *U.S. Metals*, 490 S.W.3d at 28, and *Federated Mut. Ins. Co. v. Grapevine Excavation, Inc.*, 197 F.3d 720 (5th Cir. 1999)).

²⁵³ *U.S. Metals*, 490 S.W.3d at 20.

²⁵⁴ *Midwest Fam. Mut. Ins. Co. v. Green Fuel Techs.*, 2023 WL 7494964 (D. Ariz. Nov. 13, 2023).

²⁵⁵ *Id.* at *3.

²⁵⁶ *Black & Veatch Corp. v. Aspen Ins. (Uk) Ltd.*, 378 F. Supp. 3d 975 (D. Kan. 2019).

²⁵⁷ *U.S. Metals*, 490 S.W.3d at 20.

²⁵⁸ *Mississippi Phosphates Corp. v. Furnace & Tube Service, Inc.*, 2009 WL 1448967 (S.D. Miss. May 22, 2009).

²⁵⁹ *BITCO General Ins. Corp. v. Union Ridge Ranch, LLC*, 2024 WL 3924715 (W.D. Wash. Aug. 22, 2024).

²⁶⁰ *Id.* at *8.

²⁶¹ *Gulf Ins. Co. v. Parker Products, Inc.*, 498 S.W.2d 676 (Tex. 1973).

²⁶² *Id.* at 678.

²⁶³ *See Standard Fire Ins. Co. v. Chester-O'Donley & Assoc., Inc.*, 972 S.W.2d 1 (Tenn. Ct. App. 1998) (finding that the recall exclusion does not apply to claims involving losses resulting from failure of insured's defective duct work when they are not based upon withdrawal or recall of the insured's own product or work).

²⁶⁴ *Auto Owners Ins. Co. v. Newman*, 684 S.E.2d 541 (S.C. 2009).

²⁶⁵ *Id.* at 546–47.

²⁶⁶ *Bennett & Bennett Constr., Inc. v. Auto Owners Ins. Co.*, 405 S.C. 1, 747 S.E.2d 426 (2013).

²⁶⁷ *Lamar Homes*, 242 S.W.3d at 1.

²⁶⁸ *U.S. Fire Ins. Co. v. J.S.U.B., Inc.*, 979 So. 2d 871 (Fla. 2007).

²⁶⁹ *B. Hall Contracting, Inc. v. Evanston Ins. Co.*, 447 F. Supp. 2d 634 (N.D. Tex. 2006).

²⁷⁰ *Scottsdale Ins. Co. v. Mt. Hawley Ins. Co.*, 2011 WL 9169946, 2011 U.S. Dist. LEXIS 156386 (S.D. Tex. June 15, 2011).

²⁷¹ *See Mt. Hawley Ins. Co. v. Slay Eng'g*, 390 F. Supp. 3d 794 (W.D. Tex. 2019); *Mt. Hawley Ins. Co. v. Slay Eng'g*, 409 F. Supp. 3d 587 (W.D. Tex. 2019); *Scottsdale Ins. Co. v. Mt. Hawley Ins. Co.*, 2011 WL 9169946, 2011 U.S. Dist. LEXIS 156386 (S.D. Tex. June 15, 2011); *Evanston Ins. Co. v. Europa Bldg. Assocs., Inc.*, 2019 WL 656216, 2019 U.S. Dist. LEXIS 40941 (S.D. Fla. Jan. 15, 2019).

²⁷² *Mt. Hawley Ins. Co. v. Aguilar*, 2008 WL 11342656, 2008 U.S. Dist. LEXIS 129186 (C.D. Cal. Feb. 29, 2008).

²⁷³ *Id.* at *3.

²⁷⁴ *Cincinnati Specialty Underwriters Ins. Co. v. KNS Group, LLC*, 561 F. Supp. 3d 1298 (S.D. Fla. 2021).

²⁷⁵ *Id.* at 1312.

²⁷⁶ *See California Traditions, Inc. v. Claremont Liability Ins. Co.*, 197 Cal. App. 4th 410, 127 Cal. Rptr. 3d 451 (2011) (enforcing an exclusion for work performed on condominium projects to deny coverage under the insured framing contractor's CGL policy).

²⁷⁷ *Ment Bros. Iron Works Co., Inc. v. Interstate Fire & Cas. Co.*, 702 F.3d 118 (2nd Cir. 2012).

²⁷⁸ *Id.* at 123.

²⁷⁹ *Id.* at 121.

²⁸⁰ *Nautilus Ins. Co. v. Pinnacle Eng'g & Dev. Inc.*, 2024 WL 940527 (S.D. Fla. Mar. 5, 2024).

²⁸¹ *Id.* at *17.

²⁸² *See First Mercury Ins. Co. v. Waterside Condo Ass'n*, 2013 WL 6383883 (D. Or. Dec. 5, 2013).

²⁸³ *Soule v. Woodward Design + Build, LLC*, 382 So. 3d 1052 (La. Ct. App. 2023).

²⁸⁴ *Id.* at 1060–61.

²⁸⁵ *See, e.g., Liberty Surplus Ins. Corp. v. Kaufman Lynn Construction, Inc.*, 130 F.4th 903 (11th Cir. 2025); *Tutor Perini Corp. v. American Guarantee & Liability Ins. Co.*, 2025 WL 3254596 (C.D. Cal. Nov. 18, 2025), currently on appeal to the Ninth Circuit, Case No. 25-7857.

AN EXPLANATION OF CAPTIVE INSURANCE ARRANGEMENTS FROM FORMATION TO ONGOING COMPLIANCE

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Introduction

Once thought exotic, market forces have pushed captive insurance into the mainstream of risk financing methodologies.¹ Companies have formed captives to:

- 1.) Obtain more affordable coverage,²
- 2.) Obtain more efficient coverage,³
- 3.) Obtain cheaper coverage,⁴
- 4.) Gain increased control over policy-related litigation,⁵ and
- 5.) Purchase insurance more efficiently.⁶

Although originally formed exclusively offshore,⁷ a majority of U.S. states now allow captives.

This growth has not been without controversy, as the Treasury Department has long considered captive insurance a suspect transaction. The controversy began in 1955 when an IRS house report argued offshore captives could charge excessively high premiums to drain income from the U.S. market.⁸ Despite losing a 1963⁹ group captive case,¹⁰ the Treasury stated it would not follow the decision.¹¹ This set up an extensive line of cases in which the IRS argued that any form of self-insurance was not valid for federal income tax purposes.¹² After initial victories, the IRS suffered a series of losses, eventually issuing several “safe harbor” revenue rulings in the early 2000s.¹³ This did not end the taxpayer-Treasury conflict. The IRS lost three large captive cases between 2014-2015,¹⁴ but it has scored a series of impressive victories against 831(b) micro-captives.¹⁵

Despite these issues, however, captive insurance is one of the fastest-growing areas of the insurance market for several reasons: (1) it allows an insured to use its individual loss history in the premium calculation, thereby financially rewarding companies with strong risk management practices; (2) a successful captive program can pay dividends to the parent company after a claim’s window closes; and (3) it gives the insured more oversight of the claims process. These benefits give companies far more control over the cost of their risk, granting far more transparency for one of the company’s largest expenses.

This article will first define the term captive insurer and explain pure and group structures. It will then explain how insurers calculate an insurance premium. This will be

placed in the context of determining if a company should form a captive. Next, it will explain the captive formation process, using the Texas application form as a template for the transaction.¹⁶ This will be accompanied by an analysis of fronting, claims management, and insurance company investments. Finally, the article will explain the current federal tax law requirements for an insurance company to be recognized for tax purposes.

A word of caution before moving forward: Captives are the purest expression of insurance ingenuity and creativity, in which producers, underwriters, actuaries, regulators, attorneys, claims personnel, and investment advisors collaborate to create an insurance program specifically tailored to the risk financing needs of a single insured. The unique nature and idiosyncrasies of the insurance business govern all transactional elements — from conception to winding up the captive’s operations.

However, captive insurance law is derived from a conflict between the insured and the IRS and resolved by the tax courts. But neither of these governmental entities has the same level of specialized skill as those creating and implementing a captive program. This creates an ongoing problem for the captive insurance industry: Insurance professionals can form and manage a captive in compliance with insurance industry standards yet be forced to defend the program against an administrative organization in a tribunal ill-equipped to understand the transaction. The situation creates problems for the insurance industry with no clear solution visible.

A (Very Brief) Discussion of the 831(B) Tax Election

An insurance company with less than \$2,850,000 in annual premiums can file an election to be taxed on its investment income rather than gross premiums written. For example, an insurer with premium income of \$2,000,000 but investment income of \$75,000 can use the latter figure to compute its tax liability, greatly lowering its tax burden.¹⁷ The IRS describes these insurers as micro-captives, as they are typically formed for smaller companies. This election has been a hotbed of tax controversy, with the IRS decisively winning nine cases that ruled the insurer was not valid for federal income tax purposes.¹⁸ An in-depth discussion of these decisions is beyond the scope of this article, although dicta from these cases provide helpful practitioner guidance. Due to this controversy, most practitioners counsel against the election.

Captive Insurance Defined

A captive insurance company insures the risks of a parent company and its related entities.¹⁹ For example, Acme Manufacturing forms an insurance subsidiary that sells insurance only to Acme Manufacturing and its affiliates. Larger companies form pure captives, which are “company[ies] that insure risks of its parent or affiliated companies or controlled unaffiliated businesses.”²⁰ This structure is typically not financially viable unless the parent company spends at least \$1.5 to \$2 million in premiums per year. Companies with smaller annual insurance expenses²¹ participate in group captives, which can be based on an industry (such as oil and gas or trucking) or a single risk (workers’ compensation).

Groups typically use an A/B fund structure. The first layer of risk is called the “A” fund. It absorbs “frequency claims,” so named because they occur regularly but are inexpensive to settle. The “B” fund absorbs claims from the top of the “A” fund to a level agreed upon with the fronting insurance carrier. These are called severity claims because they occur less frequently than “A” fund claims but are larger in size (*i.e.*, they are more “severe”). If a company has several of these claims, then other group members may contribute funds, creating a level of risk distribution.²² The fronting carrier pays claims from the top of the “B” fund to \$1,000,000 or \$2,000,000, after which a reinsurer absorbs losses. The following diagram illustrates this concept:

Claim Amount	Who Handles
>\$1,000,000	Reinsurer
>\$250,000	Fronting Carrier
\$100,000- \$250,000	“B” Fund/Severity
\$0-\$100,000	“A” Fund/ Frequency

Insurance Premium Defined; Captive Viability Explained

An insurance premium funds future losses and is comprised of the following variables:

- 1.) The pure loss cost (colloquially referred to as the “loss pick”):²³ the cost of funding projected losses;²⁴
- 2.) Allocated loss adjusted expenses:²⁵ the cost of adjusting a specific claim;²⁶

- 3.) Unallocated loss adjusted expenses:²⁷ the general costs of running an insurance company; and²⁸
- 4.) Profit.²⁹

Premium calculations begin with insurance company actuaries analyzing loss data from companies in specific industries (such as all long-haul trucking companies) to calculate a base rate that applies to the entire industry. Underwriters then adjust these rates for each insured to account for that company’s loss profile. Ideally, an underwriter’s adjustments should completely account for a company’s loss experience. But this is rarely the case, creating a pricing anomaly on which captive insurers can capitalize.³⁰

The following back-of-the-envelope methodology incorporates the premium pricing methodology and is commonly used by captive practitioners to determine if a company should consider a captive. Acme, Inc. owns 1,000 trucks. For the last five years, the company has had 50 accidents/year, totaling \$5,000/accident.³¹ Knowing this information, the company estimates that next year, it will pay a total of \$250,000 (50 accidents x \$5,000/accident)³² for claims. Assuming this rate accounts for 50% of the insurance premium,³³ Acme estimates its third-party insurance premium should be in the range of \$500,000. The market instead quotes \$750,000, which Acme believes is far higher than it should pay, given its superior loss history. This pricing anomaly leads Acme to consider a captive. Acme could also analyze its previous losses³⁴ relative to previous premiums³⁵ to determine if the market has overcharged the company in past years.

Captive Formation Process Explained³⁶

This explanation assumes the potential captive owner is insuring commercial auto, general liability, and/or workers’ compensation coverage.

Thanks to the rise of electronic filing, creating a new corporation is an easy and perfunctory process. CPAs, lawyers, or authorized personnel can sign onto the relevant Secretary of State’s website, fill out the appropriate documentation, and form a new company in minutes. The related paperwork arrives via email, sometimes on the same day.

Insurance company formation is not part of this paperwork revolution. An insurer is a financial intermediary,³⁷ vitally important to the functioning of the broader economy. The day-to-day operations are complex, involving nuanced legal, accounting, taxation, claims handling, investment, and underwriting.³⁸ States have an intense interest in ensuring these entities are financially sound, making insurers a heavily regulated industry.³⁹ This begins at company formation, when a prospective captive insurer must supply a large amount of information to the jurisdiction, which is then reviewed by the department of insurance's captive division.

Due to this complexity, prospective captive owners hire captive managers, who

...provide general guidance relative to the formation and application process. Once the captive is established, managers perform the daily accounting and bookkeeping work, including the quarterly or annual financial statements. Captive managers have a close working relationship with the captive regulators.⁴⁰

Once hired, a manager first writes a feasibility study, which analyzes a company's loss exposures, loss history, and current insurance program to determine whether a captive insurance program is "feasible." Actuarial analysis provides the study's backbone, including:

...pro forma financial projections: balance sheet, income statement, and cash flow statement, as well as net present value of cash flows and internal rate of return on investment. Sometimes the pro forma financial projections are built by the captive manager using loss picks, five-year projections, and loss payouts provided by the consultant or actuary.⁴¹

The captive manager presents this information to the prospective captive owner who must decide whether to form the captive.

If the company wants to move forward, then the next step is to secure key services, beginning with a fronting carrier. This is an arrangement in which an insurance policy is issued by a licensed insurance company on behalf of another party that initiates the transaction and intends to assume or retain all or part of the risk.⁴² Fronting is usually a reinsurance arrangement where the insured pays a premium to the fronting carrier, which then cedes

a large percentage of the premium (save for the fronting fee) to the captive.⁴³ Captives use fronts for the following reasons: (1) a front is admitted in the jurisdictions where the insured does business (this is, by far, the most prevalent reason);⁴⁴ (2) a fronting carrier has a credit rating, which is required by the insured's contractual counterparties;⁴⁵ and (3) the front may have underwriting expertise related to the risk underwritten for the captive.

The captive will need to hire other professionals, beginning with a third-party claims administrator, commonly called a TPA. A TPA is necessary because the claims process is regulated,⁴⁶ and claims adjusters are licensed by the state.⁴⁷ Additionally, carriers require well-known administrators for commercial auto, workers' compensation, and general liability claims. Because of insurers' unique tax status,⁴⁸ an accounting firm specializing in insurance tax also is necessary. Attorneys and investment advisors, both of whom understand insurance nuances, round out the required professional services.

Finally, the recently issued *Patel* decision requires that all captives comply with the economic substance doctrine, an anti-abuse doctrine used by courts to determine if a transaction is a tax shelter.⁴⁹ An affirmative analysis that the captives is not a tax shelter should thus be included with the study.

The Texas captive insurance application specifically lists these professionals, which also includes the feasibility study, biographical affidavits for corporate executives, captive corporate documents, administrative services contracts, a general business plan, corporate organizational chart, and draft captive insurance policies.⁵⁰

If the application is approved, then the captive can begin formal insurance operations.

The Legal Definition of Insurance Company

Considering their importance to the economy at large, practitioners would logically assume the law has developed a clear definition of the term "insurance company." The exact opposite is the case. Since insurance is regulated at the state level, there are 50 state law definitions. There is also a common law definition,⁵¹ and one contained in the Treasury Regulations.⁵² These definitions are not so distinct from one another as to lead to anarchy. But there are enough wrinkles so that a company can comply with one definition but not another.

The preceding definitions have not been the subject of meaningful litigation, which often adds interpretive nuances to the various terms and conditions. But *Harper* Test elements,⁵³ from the eponymous case, have been extensively developed⁵⁴ through tax court case law. The following discussion is based on this test and the litigation expounding its contours. The items discussed below must be present for a captive to be considered an insurance company for federal income tax purposes.

The Harper Factors

Whether the arrangement involves the existence of an “insurance risk”

What is and isn’t viable insurance coverage has been a controversial topic. Coverage for widely applicable statutorily imposed liability has not been challenged.⁵⁵ But insurance for the risks associated with owning and operating a business has caused conflict with taxing authorities.⁵⁶ The *R.V.I.*⁵⁷ case provides practitioners with a clear methodology to determine if specific coverage is valid.

The *R.V.I.* case is centered on residual value insurance. When a company leases certain property (such as a car or a large piece of equipment), it estimates the residual value or value at the end of the lease. This calculation includes depreciation, inflation, and potential technological obsolescence.

A simple example may illustrate the mechanics of a typical RVI policy. Assume that an automobile with an initial purchase price of \$20,000 is leased for three years and that its expected residual value upon lease termination is \$10,000. RVIA might insure that automobile for 90% of the expected residual value, yielding an insured value of \$9,000. If, at lease termination, the automobile had an actual residual value of \$8,500, the RVI policy would indemnify the lessor for \$500, assuming the lessor satisfied all terms and conditions of coverage. The lessor would bear the \$1,000 initial layer of loss.⁵⁸

R.V.I. was a very successful insurer, providing coverage for “754,532 passenger vehicles, 2,097 real estate properties, and 1,387,281 pieces of commercial equipment.”⁵⁹ Despite the size of the insurer’s portfolio, the Treasury determined these policies were not insurance for federal income tax purposes.⁶⁰ The taxpayer disagreed, leading to trial.

The court ruled for the taxpayer, using three factors to determine whether specific risk was valid for tax law purposes:

- 1.) Was there insurance risk? The court equated this element with underwriting risk, where the difference between the premium and the policy’s face amount is large enough that the insurer would absorb a not insignificant loss in the event it mispriced the risk. “Because the premium it charged was rarely more than 4% of the insured value, it was clearly exposed to underwriting risk, namely, the risk that the premiums charged would not be enough to cover claims paid.”⁶¹
- 2.) Did the regulator approve the policy during the application process? During the application process, the regulator will analyze the policy in detail. The state may even hire a third-party actuary for more exotic coverages. The independent review in *R.V.I.* was extensive.⁶²
- 3.) Did the professionals performing the annual review raise any concerns about the policies? Insurance companies are required to file annual reports for the preceding year’s activities. Outside professionals and actuaries are hired to perform an independent audit and analysis of the company.⁶³

The court correctly deferred to state authority and accompanying expertise to support the second and third factors.⁶⁴ This is a non-issue if a company is forming a captive for commonly issued policies such as commercial auto, workers’ compensation, and general liability. But more exotic coverages should be thoroughly vetted before committing to a captive program.

Insurance In Its “Commonly Accepted Sense”

With this factor, the tax court lists activities common to all insurers and then examines specific facts to determine if they are present. Claims processing and investment management are so axiomatic that their discussion seems superfluous. But bad facts in the micro-captive cases mandate their discussion. The method of premium calculation and policy language also emerged as flashpoints in the 831(b) election, explaining their inclusion.

• *Claims*

The discussion of premium calculation explained that actuaries analyze past losses to calculate the pure lost cost, which then forms the basis of next year's premium. This implies the captive will have at least semi-regular claims activity, which, in the case of commercial auto, workers' compensation and general liability, is accurate. The claims pattern for these risks is colloquially referred to as high frequency/low severity because, while there are many claims, they normally settle for a small amount (relatively speaking). But other risks, such as directors and officers, employment practices, catastrophic property, and cyber, have larger, irregularly occurring claims. Insurance professionals describe this claim pattern as low frequency/high severity because claims occur infrequently but are far larger in size. This lower frequency claims pattern does not make these risks any less valid, just less frequent.

The volume of annual claims has emerged as a potential flashpoint for the IRS, at least regarding 831(b) captives. Recently proposed tax code regulations⁶⁵ require micro-captives to have a minimum cumulative loss ratio of 60 percent⁶⁶ or be considered a transaction of interest,⁶⁷ leading to onerous tax reporting requirements.⁶⁸ While several taxpayers are challenging these regulations,⁶⁹ they reveal that the Treasury believes high claims activity equates to validity for federal tax purposes. For primary lines captives,⁷⁰ this is less likely to be an issue.⁷¹ But captives underwriting low-frequency/high-severity risks (such as catastrophic property) should be vetted by an independent tax adviser.

The micro-captive cases contain a number of negative fact patterns regarding claims. In these cases, claims were either non-existent,⁷² barely occurring,⁷³ reported only after a tax audit started,⁷⁴ or existing and unreported.⁷⁵ All of these facts should be considered a cautionary tale.

• *Investments*

An insurance company's primary function is to pay claims. Therefore, investments must be liquid and held in minimally volatile assets such as cash and treasury bonds. Equities — even those of large, stable companies — should be avoided until the captive has sufficient capital and surplus to fully absorb shock losses.

The micro-captive cases are replete with bad investment portfolio examples. In *Avrahami*, the captive transferred \$1.2 million to a limited partnership owned by the insured's children that invested in land.⁷⁶ Both *Syzygy*⁷⁷ and *Patel*⁷⁸ owned life insurance policies. The captive in *Royalty* made large loans to its owners,⁷⁹ while

Swift's captive bought and sold real estate.⁸⁰ None of these examples should be duplicated.

• *Premium Pricing*

The discussion above explains the actuarial method used when ample data is available to calculate future losses. When there is insufficient data, the actuary has other options. The number may be based entirely on the underwriter's judgment;⁸¹ it could be from a model such as the Monte Carlo⁸² method. The primary requirement for these non-traditional methods is that the actuary performing the analysis must leave a sufficient paper trail to allow another actuary to duplicate his work.⁸³ Non-traditional premium calculation methods were used extensively in the micro-captive cases and found wanting.

• *Valid and Binding Contracts*

The most common policies are written by Insurance Services Office, more commonly referred to as ISO. This organization submits forms to state regulators for approval; the forms are then used throughout the state. Because a policy's provisions must apply to many situations in a state (for example, it must be applicable to most negligence cases in Florida), it is broadly drafted, creating an industry-understood shortcoming of policy ambiguity.

Before the micro-captive cases, the captive caselaw regarding the requirements for valid and binding policies was limited and were, hence, a non-issue. That changed with the micro-captive cases, which included failures such as policies issued after the end of the policy year⁸⁴ or no policies issued at all.⁸⁵ But several cases found the policies invalid simply because they were ambiguous,⁸⁶ which is not an uncommon issue. The *Syzygy* court conceded this point and acknowledged it was a major source of litigation, only to then rule against the taxpayer.⁸⁷

Risk Shifting

Risk shifting is the movement of a financial loss from one legal entity to another. For example, the cost of auto liability is transferred from the truck owner to a third-party insurer via an insurance policy. If an accident occurs, then the insurer — not the owner — pays for the loss. To the lay person, this simple explanation requires no more elaboration.

But risk shifting is more nuanced and complex, especially when the transaction is self-insurance. To begin, some insurance scholars argued that self-insurance of any kind was impossible.⁸⁸ That was the Treasury's

first position, outlined in Revenue Ruling 77-316, which argued that any risk remaining within the same “economic family” was not insurance for federal income tax purposes. The ruling offered no rationale for this position.

The judicially created balance sheet test provided the necessary theoretical support.⁸⁹ It explained that since the parent company owned all the captive’s stock, the parent’s net worth, as calculated with balance sheet values, was unaffected by the captive transaction. The premium payment depleted cash but increased the captive’s share price by the same amount, resulting in no net change to the parent’s net worth. The reverse occurred when the captive paid a claim. Risk was not “shifted.” It was, instead, moved between different corporate accounts.

A diverse captive ownership structure weakens this argument, as two cases illustrate. The captive in *Crawford* was 20-percent-each owned by four subsidiaries and five-percent-each owned by four executives.⁹⁰ *Humana*’s insurer was owned 62.5/37.5 between two shareholders.⁹¹ The Tax Court ruled that both captives were valid for federal income tax purposes, in no small part due to the ownership structure.

After *Humana*, the central controversy in captive insurance litigation centered on risk distribution. But it is possible that risk shifting could reemerge as a point of contention between the Treasury and taxpayers since the issue was not so much resolved as abandoned.

Currently, accounting and actuarial standards of practice offer risk shifting guidance to captive practitioners. Statement of Financial Accounting Standards No. 113⁹² provides tests to determine if risk shifting exists in a reinsurance contract for accounting purposes, while the Risk Transfer Practice Note published in November 2022⁹³ gives the same guidance to actuaries.

Risk Distribution

Since the *Gulf Oil* case in 1990,⁹⁴ risk distribution has been the primary area of contention between taxpayers and the Treasury. Today, the case law is no closer to a serviceable standard for this element. Tax Courts and the Treasury remain the biggest impediments to a solution. While both have expert tax knowledge, neither understands insurance or the mathematical concepts underlying this industry. This leaves programs designed by seasoned insurance professionals open to attack based on concepts that these programs aren’t “insurance in its commonly accepted sense.”

As Allen Willett originally explained in his seminal insurance text, *The Economic Theory of Risk and Insurance*, an insurer assumes separate risks to lower the overall uncertainty of its portfolio.⁹⁵ For example, if a company owns and self-insures a single truck, the volatility of the potential losses ranges from \$0 to the highest liability possible for a truck accident. But if the company adds a single truck, then the portfolio’s volatility decreases, a trend that continues so long as new risks are not perfectly correlated.⁹⁶ More risks also lower the overall volatility per unit of risk.⁹⁷

Originally, insurance authors believed this was caused by the Law of Large Numbers.⁹⁸ But later insurance texts noted this was not the case.⁹⁹ As one author noted, “The law of large numbers is not used in all forms of insurance and, therefore, is not essential to the general definition of insurance.”¹⁰⁰ This is because the Law of Large Numbers has a narrow set of qualifications that don’t apply to property and casualty insurance.¹⁰¹ Unfortunately, tax court rulings continue to argue for the strict application of this doctrine,¹⁰² placing taxpayers at a tactical disadvantage.¹⁰³

Theoretically, there are three safe harbors that provide guidance on how to structure an insurer’s portfolio of risks so that it has sufficient risk distribution for federal income tax purposes. Revenue Ruling 2002-89¹⁰⁴ requires a captive to obtain more than 50 percent of its premiums from a non-parent. Revenue Ruling 2002-90¹⁰⁵ requires the captive to insure at least 12 companies, with each representing at least five percent but not more than 15 percent of the captive’s total portfolio. Newer cases focus on the need for the captive to ensure enough statistically independent risk units, which translate into the number of things covered by an insurance policy. This translates into the number of trucks for commercial auto and individual employees for workers’ compensation.

Unfortunately, none of these tests are derived from an actuarial, mathematical, or underwriting principle recognized by industry participants. There is no “rule of 50 percent” or “rule of 12” used within the insurance industry, nor do insurance professionals seek a minimum number of units for an insurer to be valid. As noted above, the academic literature notes that portfolio volatility is a function of the portfolio’s size and the statistical correlation between the individual risks contained in the portfolio.

While neither the Treasury nor the tax court has formally adopted any methodology to determine risk distribution, the actuarial profession has offered a potential solution. First published in 2021 in *Variance Magazine*,¹⁰⁶ *Expected Adverse Deviation as a Measure of Risk Distribution*,¹⁰⁷ this article offers a method to determine “[t]he reduction in the variability between expected losses and actual losses as a result of aggregating these risks.”¹⁰⁸ As of this writing, no papers questioning the article’s methodology or conclusion have been published.

Practitioners are encouraged to explore this and other methodologies with an accredited actuary.

Conclusion

No longer exotic risk-management tools, captives have risen from being a tool of a few large companies to become an attractive option for increasingly smaller enterprises. All that’s required for entry is a solid risk management program with a demonstrable record of better-than-its-peers loss results.

The increasing use of these structures has not decreased the transaction’s complexity. An insurance company is a complex financial intermediary that requires the skills of actuaries, accountants, lawyers, claims professionals, and investment managers, each of whom are aware of and sensitive to the subtle nuances of insurance company operations. Just as importantly, prospective owners must seek out and implement the advice of seasoned and specialized tax counsel who are aware of the long-running taxpayer-IRS feud and can provide solutions and structures accounting for the case-law proscribed issues.

However, these issues should not dissuade a company from considering captives. Much like a complex partnership or offshore hub-and-spoke system, captives can not only solve an existing problem but also potentially provide additional solutions that enhance the company’s financial well-being, thereby making the captive a winning proposition for an appropriate candidate.

Endnotes

¹ Richard Cutcher, *Captives Are no Longer an 'Alternative Market'*, CAPTIVE INTELLIGENCE, May 2023 (“Captives should no longer be considered an ‘alternative market’, with the volume of premium and assets under management carried by self-insurance subsidiaries demanding they be viewed as a market in their own right. . .”)

² *Stearns-Roger Corp., Inc. v. U.S.*, 577 F. Supp. 833 (D. Col. 1984) (“Since the early 1970’s, Stearns-Roger has found it difficult or impossible to obtain from traditional insurance companies the types and huge amounts of coverage needed. For that reason, Stearns-Roger decided to enter the insurance business, partly as a financial opportunity and partly to provide itself a source for insurance required to keep it in business.”).

³ *Rent-a-Ctr., Inc. v. Comm’r*, 142 T.C. 1, 4 (2014) (“In 2001, after receiving a \$3 million invoice from Travelers for claim handling fees, petitioner became dissatisfied with the cost and inefficiency associated with its bundled policies. On August 5, 2002, petitioner, with the assistance of Aon, obtained unbundled workers’ compensation, automobile, and general liability policies from Discover Re. Pursuant to an unbundled policy, an insurer provides coverage and a third-party administrator manages the claims administration process. Discover Re underwrote the policies; multiple insurers provided coverage; and Specialty Risk Services, Inc. (SRS), a third-party administrator, evaluated and paid claims.”).

⁴ *Crawford Fitting Co. v. United States*, 606 F. Supp. 136, 138 (N.D. Ohio 1985) (“Prior to establishing its own insurance company, the quotes the Crawford Companies received for insurance was generally an up front cash premium of \$850,000.00 to obtain the first one million dollars of coverage. Constance was created because the Crawford Companies were unable to secure insurance at a reasonable price and without substantial limitations on the types and amounts of risk.”).

⁵ *Beech Aircraft Corp., v. U.S.*, 797 F.2d 920 (10th Cir. 1986) (“Beech Aircraft formed Travel Air in 1972 so that it could obtain products liability insurance from Travel Air which would permit it (Beech), rather than an insurer, to control the defense of claims which might be made against Beech.”).

⁶ *Mobil Oil Corp. v. United States*, 8 Cl. Ct. 555, 557 (1985) (“Based upon the study, Mr. Adams prepared a report (Adams report) for the board of directors for Mobil Overseas. The Adams report concluded the method of Mobil Overseas and its affiliates of insurance against physical damage should be revised.”).

⁷ Caribbean Islands, often referred to as International Offshore Financial Centers or IOFCs, became hubs of offshore financial activity starting in the 1950s. Bermuda became the primary offshore insurance domicile soon thereafter.

⁸ *Tax’n of Ins. Co. Income*, 1956-1 C.B. 954 (I.R.S.

1955), (“There is a potential abuse situation in the case of the so-called captive insurance companies. It may be possible for a finance company, for example, to establish a subsidiary life insurance company that will issue life insurance policies in connection with the business of the parent. If the subsidiary charges excessive premium on this business, a portion of the income of the parent company can be diverted to the life insurance company.”).

⁹ *United States v. Weber Paper Co.*, 320 F.2d 199 (8th Cir. 1963).

¹⁰ In a group captive, companies with a similar risk or from the same industry form a captive consortium to provide coverage. For example, companies in the oil and gas business form a collectively owned pool to provide commercial general liability, worker’s compensation, and commercial auto insurance. In *Weber*, the insureds all owned property along the Mississippi river. Recent flooding drove insurers away from the market, forcing the insureds to form an insurance company.

¹¹ Rev. Rul. 1964-72.

¹² Rev. Rul. 77-316.

¹³ Rev. Rul. 2002-89, Rev. Rul. 2002-90, Rev. Rul. 2002-91.

¹⁴ *Rent-A-Ctr.*, 142 T.C. 1; *Securitas Holdings, Inc. v. Comm’r*, 108 T.C.M. (CCH) 490 (2014); *R.V.I. Guar. Co. & Subsidiaries v. Comm’r*, 145 T.C. 209 (2015).

¹⁵ Micro-captives are insurance companies that elect a special tax status under 12 U.S.C. § 831(b).

¹⁶ Available here: <https://www.tdi.texas.gov/forms/form-3captives.html> (last visited on May 29, 2025).

¹⁷ Assuming the company has no expenses, the company with \$2,000,000 in income would have \$420,000 in taxes due, while the insurer with \$75,000 in income would have \$15,750 in taxes due (the current corporate tax rate is 21 percent).

¹⁸ When this happens, the taxpayer must pay back taxes totaling the premiums paid to the insurer, plus penalties and interest. Additional costs are possible if the court rules that the transaction lacks economic substance.

¹⁹ TEX. INS. CODE § 964.001(2) (Captive insurance company means a company that holds a certificate of authority under this chapter to insure the operational risks of the company’s affiliates or risks of a controlled unaffiliated business.”).

²⁰ Vt. Stat. Ann. tit. 8, § 6001 (2018).

²¹ The company’s annual insurance expense can be as low as \$100,000 in some situations.

²² Risk distribution is an element of insurance at common law and requires that a risk be spread over other similarly situated policy holders. See discussion *supra*.

²³ The pure loss cost is the cost to pay projected claims. That amount is \$250,000 in the Acme example from the next paragraph.

²⁴ As a rule of thumb, projected loss costs account for about 50 percent of insurance premiums. For example, a \$500,000 premium implies a pure lost cost (or projected losses) of \$250,000.

²⁵ GEOFF WERNER ET AL., BASIC RATEMAKING 40, (Casualty Actuarial Society, 5th ed. 2016).

²⁶ For example, the cost of the claim (fixing a specific auto; paying wages for an insured employee; paying for costs associated with that claim).

²⁷ BASIC RATEMAKING at 121.

²⁸ Total expenses account for approximately 40 percent of all insurance premiums.

²⁹ Please see Actuarial Standard of Practice No. 30 for additional discussion.

³⁰ While insurers that front captive programs are supposed to use the specific company's loss history exclusively, it's common for insurers to instead rely on industry-level data in the premium calculation, which removes a key benefit of a captive. It's therefore imperative that, as part of the formation process, a captive hire an independent actuary for a fronted insurance program.

³¹ BASIC RATEMAKING at 6-7 (The former is referred to as frequency, or the number of events per period. The latter is referred to as severity, or the average dollar amount per claim.).

³² *Id.* at 8 (Frequency x Severity = pure loss cost).

³³ *See* n. 25.

³⁴ The company's insurance producer can request the loss runs for all insured losses. These are then compared to the premium for each line of coverage for a specific year.

³⁵ This is colloquially referred to as a "look-back" analysis.

³⁶ For additional information and discussion on this topic, please see F. HALE STEWART, DESIGNING A RISK FINANCING PROGRAM (2023); DON RIGGIN, GUIDE TO CAPTIVES AND ALTERNATIVE RISK FINANCING (The National Underwriter Company 2013); KATHRYN WESTOVER, CAPTIVES AND THE MANAGEMENT OF RISK (IRMI 2013).

³⁷ A financial intermediary sits between two economic sectors (such as consumers and businesses). It accepts smaller dollar contributions, pools them, and then pays them out to other parties. In the case of insurers, premiums would represent the smaller dollar contributions, while claims payments and investments would represent the payments to other parties.

³⁸ P.A. BAWCUTT, CAPTIVE INSURANCE COMPANIES 83-84 (Woodhead-Faulkner Cambridge 1982).

³⁹ Texas has an extensive regulatory framework for insurers. For more, please see this page: (<https://statutes.capitol.texas.gov/?link=IN>); other states have similar frameworks. The National Association of Insurance Commissioners promulgates model laws to create a certain amount of uniformity across the states.

⁴⁰ GUIDE TO CAPTIVES AND ALTERNATIVE RISK FINANCING, Location 2984 of 5507.

⁴¹ *Id.* at 3153 of 5507.

⁴² Glossary of Insurance and Risk Management Terms at International Risk Management Institute (IRMI), Fronting: <https://www.irmi.com/term/insurance-definitions/fronting>.

⁴³ GUIDE TO CAPTIVES AND ALTERNATIVE RISK FINANCING at 2722 of 5507.

⁴⁴ An admitted carrier has also submitted insurance forms to the jurisdiction for approval, submitted to regulation, and has had its rates reviewed and approved.

⁴⁵ For example, a trucking company's contractual counter parties usually require proof of insurance from a carrier with a specific credit rating.

⁴⁶ TEX. INS. CODE § 542.001 *et seq.*

⁴⁷ TEX. INS. CODE § 4101.001 *et seq.*

⁴⁸ 26 U.S.C. Subtitle A, Chapter 1, Subchapter L focuses exclusively on insurance companies.

⁴⁹ *Patel v. Comm'r*, 165 T.C. No. 10 (Nov. 12, 2025).

⁵⁰ Texas Captive Insurance Application, available here: (<https://www.tdi.texas.gov/forms/form3captives.html>)

⁵¹ 1 Couch on Ins. § 1:6 (2025 Ed.) ("Essentially, insurance is a contract by which one party (the insurer), for a consideration that usually is paid in money, either in a lump sum or at different times during the continuance of the risk, promises to make a certain payment, usually of money, upon the destruction or injury of "something" in which the other party (the insured) has an interest.").

⁵² Treas. Reg. §1.801-3(a) ("The term insurance company means a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Thus, though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code.").

⁵³ *The Harper Grp. and Includible Subsidiaries v. Comm'r*, 96 T.C. 45, 58 (1991) ((1) whether the arrangement involves the existence of an "insurance risk"; (2) whether there was both risk-shifting and risk- distribution; and (3) whether the arrangement was for "insurance" in its commonly accepted sense.)

⁵⁴ One of these factors (risk distribution) has been erroneously explained by the courts, creating problematic situation for insureds.

⁵⁵ For example, worker's compensation and commercial auto are mandated by state and federal law. Employment and environmental law are in the federal code, giving them broad application.

⁵⁶ For example, tax insurance (<https://alliant.com/risk-management/alliant-specialty/mergers-acquisitions/tax-insurance/>) and supply chain disruption coverage (<https://www.aon.com/insights/articles/2022/mitigate-supply-chain-risk-with-trade-disruption-insurance>.) were once considered exotic but are now available. But Loss of key person and Contract — which can also be priced (*see* GEORGE L. HEAD ESSENTIALS OF THE RISK MANAGEMENT PROCESS 86-87, 172-74

(1985)) — are more likely to be scrutinized by the IRS in a tax audit.

⁵⁷ *R.V.I.*, 145 T.C. 209.

⁵⁸ *Id.* at 6.

⁵⁹ *Id.* at 9.

⁶⁰ *Id.* at 16 (Because the policies weren't insurance for tax purposes, the Treasury required the taxpayer to recalculate its taxes under a different — and less beneficial — section of the tax code).

⁶¹ *Id.* at 45.

⁶² *Id.* at 48 (“... petitioner’s regulators and external auditors have uniformly concluded that its policies involve “insurance risk.”).

⁶³ *Id.* at 48-49 (“During 2006 RVIA was required to file statutory financial statements prepared in accordance with SAP. These rules forbid an insurer in its statutory financial statements to treat a contract as ‘insurance’ unless the insurer assumes a significant risk under the contract and faces a reasonable possibility of incurring a significant loss. See SSAP 62R. By issuing an unqualified opinion that RVIA’s statutory financial statements were fairly stated under SAP, its external auditor agreed that it bore a significant ‘insurance risk.’ The Connecticut Insurance Department examined RVIA’s 2006 statutory financial statements for compliance with SAP and agreed with this assessment. As Professor Angelina noted, if there had been no underwriting or insurance risk, ‘I would expect the various reports to have highlighted this issue. This has been my past experience with the large accounting firms and regulatory agencies.’”).

⁶⁴ *Id.* at 48 (“As noted earlier, Congress generally has delegated to the individual States the authority to regulate the business of insurance.” See McCarran- Ferguson Act, Pub. L. No. 79-15, 59 Stat. 33 (1945) (codified as amended at 15 U.S.C. §§ 1011-1015 (2006)); *Barnett Bank of Marion County, N.A. v. Nelson*, 517 U.S. 25, 40 (1996) (“Congress ‘moved quickly,’ enacting the McCarran-Ferguson Act ‘to restore the supremacy of the States in the realm of insurance regulation.’”) (quoting *Dep’t of Treasury v. Fabe*, 508 U.S. 491, 500 (1993)).”)

⁶⁵ Micro-Captive Listed Transactions and Micro-Captives Transactions of Interest, 90 Fed. Reg. 3534 (Jan. 14, 2025).

⁶⁶ *Id.*

⁶⁷ Treas. Reg. §1.6011-4(b)(6).

⁶⁸ The taxpayer must disclose material elements of the transaction on form 8886. This form is attached to the insured’s tax return. On arrival at the IRS, form 8886 is sent to the Office of Tax Shelter Analysis.

⁶⁹ Ryan LLC Challenges IRS Micro-Captive Insurance Rule in Federal Court, January 23, 2025, Captive.com; (<https://www.captive.com/news/ryan-llc-challenges-irs-micro-captive-insurance-rule-in-federal-court>); SRA 831(b) Admin and Affiliates Sue IRS over Final Micro-Captive Regulations, June 5, 2025, Captive.com ([https://www.captive.com/news/sra-831\(b\)-admin-and-affiliates-sue-irs-over-final-micro-captive-regulations](https://www.captive.com/news/sra-831(b)-admin-and-affiliates-sue-irs-over-final-micro-captive-regulations)).

⁷⁰ Captives insuring commercial auto, workers compensation, and general liability coverages are sometimes referred to as primary, three-lines captives.

⁷¹ However, if these captives have a superior loss history, they may fall short of the 60-percent loss ratio requirement, potentially making them suspect.

⁷² *Patel v. Comm’r*, T.C. Memo 2024-34, at *19 (Mar. 26, 2024).

⁷³ *Swift v. Comm’r*, T.C. Memo. 2024-13, at *10 (Feb. 1, 2024), *aff’d*, No. 24060270, 2025 WL 1949147 (5th Cir. July 16, 2025); *Keating v. Comm’r*, T.C. Memo 2024-2, at *32 (Jan. 4, 2024); *Reserve Mech. Corp. v. Comm’r*, T.C. Memo. 2018-86, at *48 (June 18, 2018), *aff’d*, 34 F.4th 881 (10th Cir. 2022).

⁷⁴ *Avrahami v. Comm’r*, 149 T.C. 144, 196 (2017).

⁷⁵ *Syzygy Ins. Co. v. Comm’r*, T.C. Memo 2019-34 at *13.

⁷⁶ *Avrahami*, 149 T.C. 144 at 169.

⁷⁷ *Syzygy*, T.C. Memo. 2019-34 at *21.

⁷⁸ *Patel*, T.C. Memo. 2024-34 at *8.

⁷⁹ *Royalty Mgmt. Ins. Co. v. Comm’r*, T.C. Memo 2024-87 at 26 (2024).

⁸⁰ *Swift*, T.C. Memo. 2024-13 at *12.

⁸¹ JOSEPH F. MANGAN, ET, AL, UNDERWRITING PRINCIPLES 157 (American Institute for Chartered Property Casualty Underwriters 2000) (“Judgement rates are developed by reviewing individual account characteristics and not from a classification plan that is backed with substantial loss experience.”).

⁸² The Monte Carlo method uses computers to run thousands of simulations to determine the most likely statistical outcome.

⁸³ Actuarial Standards Board, Actuarial Standard of Practice No. 9 (“This standard requires documentation of an actuarial work product whether or not there is a legal or regulatory requirement for the documentation. Appropriate records, worksheets, and other documentation of the actuary’s work should be maintained by the actuary and retained for a reasonable period of time. Documentation should be sufficient for another actuary practicing in the same field to evaluate the work.”).

⁸⁴ *Caylor Land & Dev., Inc.*, T.C. Memo. 2021-30, at *43 (Mar. 10, 2021).

⁸⁵ *Royalty Mgmt.*, T.C. Memo 2024-87, at *45.

⁸⁶ *Keating*, T.C. Memo. 2024-2, at *28; *Swift*, T.C. Memo. 2024-13, at *29.

⁸⁷ *Syzygy*, T.C. Memo. 2019-34, at *42.

⁸⁸ IRVING PFEFFER, INSURANCE AND ECONOMIC THEORY 47 (The S.S. Huebner Foundation 1956) (“In this sense, Self-Insurance is on more insurance than is education or any other uncertainty- reducing institution.”)

⁸⁹ *Malone & Hyde, Inc. & Subsidiaries v. Comm’r*, 66 T.C.M. (CCH) 1551 (1993); *Humana Inc. v. Comm’r*, 881 F.2d 247, 253 (6th Cir. 1989).

⁹⁰ *Crawford Fitting Co. v. U.S.*, 606 F. Supp 136, 138 (N.D. Ohio 1985).

⁹¹ *Humana Inc. and Subsidiaries v. Comm'r*, 50 T.C.M (CCH) 784, 786 (1985).

⁹² Financial Accounting Standards Board (FASB) No. 113.

⁹³ Risk Transfer Practice Note Developed by the Committee on Property and Liability Financial Reporting of the American Academy of Actuaries.

⁹⁴ *Oil Corp. v. Comm'r*, 914 F.2d 396 (3rd Cir. 1990).

⁹⁵ ALLAN H. WILLETT, *THE ECONOMIC THEORY OF RISK AND INSURANCE* 107 (The Columbia University Press, 1901) (“What the increase in the number of separate risk in the group does bring about is a reduction of the uncertainty for the group as a whole.”).

⁹⁶ For a detailed discussion of this phenomenon, please see HARRINGTON AND NIEHAUS, *RISK MANAGEMENT AND INSURANCE* (McGraw-Hill 2004), Ch. 4, Pooling Arrangements and the Diversification of Risk.

⁹⁷ For a detailed discussion of this, please see NEIL A. DOHERTY, *CORPORATE RISK MANAGEMENT* (McGraw-Hill 1985), Ch. 5, Portfolio Theory and Risk Management.

⁹⁸ F. Hale Stewart, *Risk Distribution: A History and the Law of Large Numbers Fallacy*, IRMI, May 2, 2024, available here: (<https://www.irmi.com/articles/expert-commentary/risk-distribution-a-history-and-the-law-of-large-numbers-fallacy>), last visited June 18, 2025.

⁹⁹ F. Hale Stewart, *Captives: The Harper Test*, IRMI, Jan. 3, 2025, available here: (<https://www.irmi.com/articles/expert-commentary/captives-the-harper-test>) Last visited on June 18, 2025. (This article cites seven different texts for the proposition that the Law of Large Numbers does not apply to insurance).

¹⁰⁰ Scott A. Taylor, *Taxing Captive Insurance: A New Solution for an Old Problem*, 42 Tax Law. 859, 882 (1989).

¹⁰¹ Gordon Thompson, *The Law of Large Numbers*, IRMI, May 3, 2024, available here: (<https://www.irmi.com/articles/expert-commentary/the-law-of-large-numbers>); last visited on June 18, 2025.

¹⁰² *Avrahami*, 149 T.C. at 181 (“Risk distribution is one of the common characteristics of insurance identified by the Supreme Court in *Le Gierse*, and occurs when the insurer pools a large enough collection of unrelated risks. The idea is based on the law of large numbers—a statistical concept that theorizes that the average of a large number of independent losses will be close to the expected loss.”); *Securitas Holdings*, 108 T.C.M. (CCH) 490, T.C. Memo. 2014-225, at **25-26 (“Risk distribution incorporates the law of large numbers which has been described as follows: ‘As the size of the pool increases, the chance that the loss per policy during any given period will deviate from the expected loss by a given amount (or proportion) de-

clines.”); *Malone*, 66 T.C.M. (CCH) 1551, T.C. Memo. 1993-585, at *14 (“We also conclude that risk distribution is present in this case. Risk distribution is viewed as accomplishing one or more of the following: (1) spreading losses among insureds; (2) providing an insurance company with a pool of premiums from which to pay losses; and (3) serving as a prerequisite to the application of the ‘law of large numbers’.”); *Clougherty Packing Co. v. Comm'r*, 811 F.2d 1297, 1300 (9th Cir. 1987) (“Risk distribution incorporates the statistical phenomenon known as the law of large numbers. This law is reflected in the financial world by the diversification of investment portfolios and in the day-to-day world by the adage ‘Don’t put all your eggs in one basket’.”).

¹⁰³ While not stated in any ruling, its possible the Treasury continues to make this argument because the name (“Law of Large Numbers”) strongly implies that only very large captives are valid at law. Please see the material referenced in footnotes 84 and 85.

¹⁰⁴ Rev. Rul. 2002-89.

¹⁰⁵ Rev. Rul. 2002-90.

¹⁰⁶ From the website: “*Variance* is a peer-reviewed, open-access journal that disseminates original practical and theoretical research in casualty actuarial science.” Last visited on June 23, 2025, (<https://variancejournal.org/about>) .

¹⁰⁷ Derek W. Freihaut et al., *Expected Adverse Deviation as a Measure of Risk Distribution*, *Variance Journal*, Vol, 14, Issue 2, 2021.

¹⁰⁸ *Id.*

SO YOU’VE GOT A VERDICT . . . WHAT NOW?! POST-VERDICT PROCEDURE AND PRACTICE TIPS FOR TEXAS INSURANCE LAWYERS

By: **WILLIAM EDWARD MCMICHAEL**

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¹ This article republishes McMichael’s prior work of the same title, which was honored by the Texas Bar College with the 2025 Franklin Jones Best CLE Article Award.

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Imagine a client retains you as coverage counsel on the eve of a trial pending in Texas state court. The plaintiffs, the families of two deceased oilfield workers, filed a lawsuit in Bexar County to recover damages after their loved ones died tragically in a fire. Each defendant has liability insurance as required under the master services agreements, but the plaintiffs insist that the reasonable damages value is higher than the current settlement offer. What is more, plaintiffs' counsel — a respected attorney with a winning history — refuses to settle with individual defendants. "If I'm trying it against one of you, I'm trying it against *all* of you," he says.

As you gather more facts, your level of concern increases. While the insurer agreed to defend the case, it issued a reservation of rights letter early in the case, noting that certain policy provisions could operate to bar coverage, depending on the jury's verdict. Additionally, defense counsel believes that the insured has strong liability defenses, but acknowledges that a jury might not believe the insured's version of the facts. She also admits there is an outside possibility for the verdict to exceed policy limits, but believes the jury verdict will likely fall within policy limits. As a result, the insurer has declined to accept offers to settle the case for policy limits.

After a hard-fought trial, the jury comes back with a verdict. It is the worst-case scenario. The insured has been found liable, and the damages the jury awarded far exceed policy limits. To make matters worse, the jury verdict includes findings of fact which, if affirmed, could result in coverage being excluded. But defense counsel insists that there is a good chance that the verdict is reversed, either during post-verdict motions or on appeal, and recommends continuing to fight.

Your client calls you and asks a simple question: "What do we do now?"

You pause and think: "Well, what *do* we do now? Does the insurer have a duty to indemnify? Is there anything that should be done before the final judgment is entered? What is a final judgment? Does the insurer still have to defend? Does the insured get new lawyers? What about an appellate lawyer? Will there be a coverage fight? If so, when? What should I say?"

* * * * *

These questions may appear straightforward, but it is surprising how rarely Texas insurance coverage practitioners deal with these issues. The reason why is obvious: very few matters go to trial anymore, and even fewer reach a jury verdict (much less final judgment). As

a result, opportunities for practitioners to interact with post-verdict issues decrease yearly.

Nevertheless, such issues are persistent and will follow us as long as the right to a jury trial remains inviolate.¹ Therefore, it is incumbent upon Texas insurance coverage practitioners to be familiar with these issues to properly advise clients if they are ever presented with scenarios like those mentioned above.

1. DOES THE RENDITION OF A JURY VERDICT TRIGGER AN INSURER'S DUTY TO INDEMNIFY?

Generally, no. The general insuring grant for the industry-standard commercial liability policy form states that an insurer "will pay those sums that the insured *becomes legally obligated to pay as damages* because of 'bodily injury' or 'property damage' to which this insurance applies."² Under Texas law, a verdict does not entitle a plaintiff to recover legal damages — only entry of a final judgment does.³

As the Texas Supreme Court noted in *In re USAA Gen. Indem. Co.*:

Integral to the distinction [between jury verdict and final judgment] is the trial court's ability to determine whether the verdict is proper and supported by evidence before rendering judgment. In making those determinations, a trial court can render judgment notwithstanding the verdict, disregard an unsupported jury finding, or grant a new trial. Thus, to ensure the determination's finality and provide adequate procedural protections for both the insured and the insurer — the judgment — not the verdict — establishes the amount a [claimant] is 'legally entitled to recover'.⁴

For this reason, Texas law provides that an insurer's duty to indemnify generally is not triggered until after the underlying lawsuit has been resolved by the entry of a final, enforceable judgment.⁵

Accordingly, the mere entry of a verdict against an insured generally does not, in and of itself, trigger an insurer's duty to indemnify.⁶ However, as detailed further below, the fact that an insurer's duty to indemnify is not fully ripe does not shield an insurer from all consequences that proximately flow from the rendition of a verdict against its insured.⁷

2. WHAT IS A “FINAL JUDGMENT”?

It depends, as the term “final judgment” can mean different things in different contexts.

For example, a judgment is “final” for purposes of establishing appellate jurisdiction if the judgment is “one that disposes of all parties and all issues in a lawsuit.”⁸

Texas courts also use the term “final judgment” when referencing the time when a court’s power to alter the judgment ends, or when the judgment becomes “final” (*i.e.*, operative) for *res judicata* or collateral estoppel purposes.⁹

“Final judgment” is also used to describe when a judgment operates to finally vest rights between the parties.¹⁰ For example, if a trial court’s judgment is appealed, and its execution is stayed by the posting of a supersedeas bond (or other instrument), then the judgment does not become a “final judgment” for execution purposes until the case is disposed of on appeal, even though it may otherwise be a “final judgment” for the purposes of establishing appellate jurisdiction or preclusive effect.¹¹

Texas law generally applies the *third* use of the term “final judgment” when analyzing whether an insurer’s duty to indemnify has been triggered. This is because, as noted above, liability insurance policies generally condition an insurer’s duty to indemnify upon the insured bearing a legal obligation to pay damages to a claimant.¹² As such, if the insured does not have a present obligation to pay damages, then the insurer’s obligation to indemnify generally is not yet triggered.¹³ Conversely, if judgment is entered against an insured, and that judgment is not superseded, then the judgment is a “final judgment” for purposes of triggering an insurer’s duty to indemnify, even though the judgment may be reversed, modified, or vacated on appeal.¹⁴

This is not to say that an insured cannot file suit against its insurer prior to the rendition of a final, enforceable judgment.¹⁵ But given the frequent misuse or confusion regarding the term “final judgment,” Texas insurance practitioners must know and understand its different meanings, and be able to articulate such to state and federal courts alike. Such may be the difference in your client prevailing in the early stages of a coverage action following a verdict.

3. WHAT HAPPENS BETWEEN THE TIME VERDICT IS RENDERED AND FINAL JUDGMENT IS ENTERED?

Several different procedural rules govern the process for entering a judgment on a verdict, as well as for challenging a verdict to avoid the entry of judgment thereon. Admittedly, post-verdict motion practice is a highly technical and nuanced area of law that requires a more comprehensive discussion than this article can provide.¹⁶ However, insurance practitioners must be aware of the general landscape of Texas post-verdict procedure to advise clients effectively.

A. Motion for Entry of Judgment.

While the Texas Rules of Civil Procedure do not mention a specific process for presenting a final judgment to the Court for entry, Rule 305 states that “[a]ny party may prepare and submit a proposed judgment for the court for signature.”¹⁷ As such, most Texas courts will require that a motion for entry of judgment be filed before they fulfill their procedural mandate to render judgment on the jury’s verdict.¹⁸

Although motions for entry of judgment are insufficient to preserve error, the filing of a motion for judgment may waive the right to complain of error on appeal in some circumstances. For example, the Texas Supreme Court has held that a losing party’s filing of a motion for judgment may be an affirmation of the jury’s verdict and waive any right to argue that the verdict is not supported by the evidence.¹⁹ The Texas Courts of Appeals are also split on the extent of the waiver that the filing of a motion for judgment may cause.²⁰ Accordingly, in cases where an insured is not the prevailing party, lawyers representing the insured should generally refrain from filing a motion for entry of judgment, even if the opposing party refuses to do so, to avoid the risk of waiving the insured’s right to challenge the judgment.

B. Motion for JNOV/JMOL + Motion to Disregard Jury Findings.

Texas Rule of Civil Procedure 301 states that, upon “reasonable motion and reasonable notice,” a trial court “may render judgment non obstante veredicto if a directed verdict would have been proper,” or “disregard any jury finding on a question that has no support in the evidence.”²¹ However, Rule 301 does not outline any specific procedure for filing such a motion.²² What is more, the Texas Courts of Appeals historically disagreed on the deadline to file a motion for JNOV.²³

There are several reasons to file a motion for JNOV: (1) there is no evidence to support a jury finding; (2) a factual issue was established as a matter of law that is contrary to a jury finding; (3) a legal principle prevents a party from prevailing on its claim or defense; or (4) a jury finding is immaterial.²⁴

By filing a motion for JNOV, a party preserves its right to make a legal sufficiency challenge to the verdict later on appeal.²⁵ When a motion for JNOV addresses the sufficiency of the evidence to support an element of a claim or defense, an appellate court will review the granting or denial of the motion under a legal sufficiency standard of review (*i.e.*, whether the evidence at trial could enable reasonable and fair-minded people to reach the verdict).²⁶ However, when the JNOV raises a non-identifiable claim, the appellate court reviews the granting or denial of the motion *de novo*.²⁷

C. Motion for New Trial.

Under Rule 320, a trial court may set aside a judgment and grant a new trial for good cause, whether on the motion of a party *or* the court's own motion.²⁸ The purpose of a motion for new trial is to give the trial court an opportunity to correct any mistakes, to preserve error, and to extend appellate deadlines.²⁹ Indeed, such motions are intended to allow trial courts to review the verdict "with more deliberate consideration than is practicable during trial" so that the court can have a "fair opportunity to correct the errors or grant a new trial if need be."³⁰

The Texas Rules of Civil Procedure require that parties assert specific grounds for a new trial, and prohibit generalized motions.³¹ In other words, a litigant cannot move for new trial based upon mere dissatisfaction with the verdict, or with the outcome of trial. That said, nearly any complaint that would justify an appellate court's reversal of judgment is sufficient reason for a trial court to grant a new trial.

While motions for new trial are not always necessary to preserve error, they are a prerequisite to asserting the following complaints on appeal: (1) a complaint on which evidence must be heard, such as one of jury misconduct or newly discovered evidence or failure to set aside a default judgment; (2) a complaint of factual insufficiency of the evidence to support a jury finding; (3) a complaint that a jury finding is against the overwhelming weight of the evidence; (4) a complaint of inadequacy or excessiveness of the damages found by the jury; and (5) incurable jury argument if not otherwise ruled on by the trial court.³² Filing of a motion for new trial, however, does not alleviate litigants from the requirement of also objecting during trial to preserve error.³³

Litigants must file motions for new trial within thirty days after final judgment is signed.³⁴ Such motion extends the trial court's plenary power to grant a new trial until thirty days after such motion has been overruled, whether by written order or by operation of law.³⁵ The filing of a motion for new trial also extends the deadline to file a notice of appeal to ninety days after the judgment is signed.³⁶

Any order granting a motion for new trial must clearly state the reasons for the new trial, as it is no longer sufficient for a trial court to grant a new trial "in the interest of justice."³⁷ In setting forth the specific reasons, trial courts may not use "and/or" prior to each stated reason as such can create ambiguity.³⁸ Failure to request that a trial court clarify the reasons for granting a motion for a new trial may risk waiver of any objections to such an order.³⁹

D. Motion for Remittitur.

A motion for remittitur is a request that the trial court suggest remittitur to the prevailing party and condition a new trial on rejection thereof.⁴⁰ In other words, it is a request that the trial court give a prevailing party an option of voluntarily reducing the amount of damages that it can recover against a defendant, or risk the trial court ordering a new trial on its own motion.⁴¹

Ordinarily, the reason for filing a motion for remittitur is that the prevailing party realizes that it may not be entitled to the full amount of the judgment that has been entered, but would prefer to voluntarily reduce the amount of the judgment to avoid the time and expense of an appeal, or otherwise avoid the possibility of reversal. If a party makes the remittitur at the trial court's suggestion, and the other party appeals, the remitting party is not barred from arguing on appeal that all or part of the remittitur should not have been required.⁴²

E. Motion for Judgment Nunc Pro Tunc.

Under Texas Rule of Civil Procedure 316, the trial court may correct a clerical mistake in the record of a judgment, in open court, after notice to all parties.⁴³ Examples of clerical errors that may be corrected by a motion for judgment nunc pro tunc include:

- Incorrect spelling of a party's name.⁴⁴
- Failing to award attorneys' fees in a judgment, where the judge had announced his judgment by letter, and that judgment awarded attorney's fees, but the judgment prepared by counsel inadvertently omitted attorneys' fees.⁴⁵

- Judgment for defendant on a promissory note secured by a ring, which inadvertently awarded possession of the right to the plaintiff, when the balance of the judgment clearly indicated that the court intended to award possession of the ring to the defendant.⁴⁶

F. Motion to Vacate, Modify, Correct, or Reform the Judgment.

Motions to vacate, modify, correct, or reform the judgment are not discussed in detail in the Texas Rules of Appellate Procedure, and there is not an extensive body of case law pertaining to these motions. However, Texas Rule of Civil Procedure 306a makes specific reference to a trial court's broad plenary power to vacate, modify, correct, or reform a judgment.⁴⁷ Additionally, the Texas Rules require that such a motion must "specify the respects in which the judgment should be modified, corrected, or reformed."⁴⁸ Such motions are appropriate in cases where the mistakes are judicial, rather than clerical, such that a motion for judgment nunc pro tunc is inappropriate, but the errors do not require further litigation.

Motion to vacate, modify, correct, or reform a judgment must be filed during the time that the trial court has plenary power over a case (*i.e.*, originally, thirty days).⁴⁹ However, the filing of such a motion extends the trial court's plenary power "until thirty days after all such timely-filed motions are overruled, either by a written or signed order or by operation of law, whichever occurs first."⁵⁰ If the trial court does not overrule the motion, then it is overruled by operation of law after seventy-five days after the date of final judgment.⁵¹

If a judgment is modified, corrected, or reformed, then the previous judgment should be vacated in its entirety, and an entirely new judgment should be submitted to the court for signature, rather than an order specifying the changes in the prior judgment, or an attempt to strike out erroneous information in the prior judgment.⁵²

4. IS THE INSURED ENTITLED TO INDEPENDENT COUNSEL AFTER THE RENDITION OF A VERDICT?

Maybe. As noted above, liability insurance policies generally impose a duty on insurers to defend their insureds, but allow the insurer the right to conduct the defense. In Texas, the right to conduct the defense includes the authority to select the attorney who will defend the claim and the authority to make other decisions that normally would be vested in the insured as the named party in the case.⁵³

Under certain circumstances, however, an insurer may not insist upon its contractual right to control the defense.⁵⁴ In *Davalos*, the Texas Supreme Court concluded that an insurer may not control the defense if the insurer is burdened by an actual conflict of interest with its insured.⁵⁵ The potential conflict of interest becomes an actual conflict of interest that prevents the insurer from controlling the defense when "the facts to be adjudicated in the liability lawsuit are the same facts upon which coverage depends."⁵⁶ Where such a conflict exists, insureds are entitled to select independent counsel, thereby protecting them from "an insurer-hired attorney who may be tempted to develop facts or legal strategy that could ultimately support the insurer's position that the underlying lawsuit fits within a policy exclusion."⁵⁷

Texas courts have yet to fully analyze how the rendition of a verdict impacts an insured's right to independent counsel, as the cases analyzing such issues do so in the pre-verdict context. But given the authority above, certain scenarios *may* entitle an insured to independent counsel.

Imagine a lawsuit alleging intentional torts and negligence-based torts for the same conduct (*e.g.*, employee driver strikes pedestrian while operating company vehicle; a bar fight, etc.). While most liability insurance policies exclude coverage for intentional conduct, the Texas Supreme Court has made clear that an insurer's issuing a reservation of rights letter does not by itself create a conflict of interest sufficient to justify independent counsel.⁵⁸ As such, insurers often defend such cases, subject to a reservation of rights.

But imagine if the jury verdict answers "YES" on the intentional conduct question. Were the court to enter judgment on that verdict, and were such verdict affirmed on appeal, such would eliminate the insurer's obligation to indemnify the loss. But if there are meritorious grounds for an appeal, then it is in the insured's best interest to work to overturn the judgment. Under these circumstances, there is a direct conflict of interest for the insurer: does the insurer continue to prosecute an appeal, and, in doing so, ensure its potential liability for the verdict? Or does the insurer stop defending the insured, accept the verdict, and eliminate its liability exposure?

Davalos and the general balance of equities appear to suggest that independent counsel should be appointed to represent the insured's interests under the circumstances. After all, the "facts [that have been adjudicated]" would be the same as the "facts upon which coverage depends."⁵⁹ But given that the Texas courts have yet to issue an opinion directly on point, future cases may contradict or conflict with the analysis above. Therefore, insurance

law practitioners should keep a watchful eye for cases that allow courts to clarify these issues.

5. IS THE INSURED ENTITLED TO APPELLATE COUNSEL AFTER THE RENDITION OF A VERDICT?

Likely, yes. Under Texas law, an insurer's duty to defend an insured against third-party liability claims is generally determined by the "four corners" of the factual allegations in the underlying petition and the "four corners" of the insurance policy, without regard to the truth or falsity of those allegations and without reference to facts otherwise known or ultimately proven.⁶⁰ Texas courts are required to "resolve all doubts regarding the duty to defend in favor of the duty" and to "construe the pleadings liberally."⁶¹

No Texas state court has addressed this issue in substantive detail.⁶² The standard ISO liability coverage form is likewise silent as to whether an insurer must prosecute an appeal.⁶³

That said, when an insurance policy is capable of more than one interpretation, Texas law requires that the policy must be construed in favor of the insured.⁶⁴ Accordingly, federal courts applying Texas law consistently hold that "Texas courts would likely interpret Texas law to be that, in the absence of an express policy provision to the contrary, an insurer's duty to defend includes a duty to appeal an adverse judgment against its insured if there are reasonable grounds for appeal."⁶⁵ Similarly, courts in jurisdictions across the country have held that, absent an express provision in the policy to the contrary, an insurer's duty to defend encompasses a duty to appeal an adverse judgment as long as there are reasonable grounds to believe that the insured's interest would be furthered by the appeal.⁶⁶ Therefore, Texas insureds are likely entitled to the appointment of appellate counsel to prosecute any meritorious argument on appeal.

6. WHAT IS A SUPERSEDEAS BOND? WHAT DUTY DO INSURERS HAVE TO SUPERSEDE A JUDGMENT?

A supersedeas bond is one that prevents execution on a judgment pending appeal. After a trial court enters a final judgment, Texas law provides that the clerk of the court "shall issue the execution upon such judgment" after thirty days thereof, or otherwise after thirty days from the time that any motion for new trial is overruled.⁶⁷ This rule applies even when a party is appealing a final judgment.⁶⁸ As such, even if an insurer complies with its duty to defend and timely appeals a final judgment en-

tered against its insured, the insured will still be liable to pay damages if the claimant executes on the judgment in the interim.

The only exception to this general rule is when a party seeking to avoid execution on the judgment *supersedes* the judgment by posting security to ensure the judgment creditor of its ability to collect after the appeal.⁶⁹ Under the Texas Rule of Appellate Procedure, the four means of superseding a judgment are (1) supersedeas bond; (2) deposit in lieu of bond; (3) written agreement with a judgment creditor to suspend execution; or (4) alternative security.⁷⁰

Texas law does not impose a general duty on insurers to supersede a judgment, much less to post a supersedeas bond (although policy terms may require an insurer to do so). But given that an insurer's duty to indemnify is contingent upon its insured bearing a legal obligation to pay damages, failure to supersede a judgment will likely trigger an insurer's duty to indemnify.⁷¹ Moreover, any subsequent failure to indemnify an insured, even while an appeal is pending, may expose insurers to additional contractual or extra-contractual liability.⁷²

Issues with superseded bonds usually arise when determining what amount the insurer must contribute toward a bond if the amount of the judgment exceeds policy limits (e.g., payment of bond for policy limits vs. the full amount of the judgment, etc.). Admittedly, no Texas court has directly answered this question, leaving room for fights about the "right answer" in the context of the facts of a particular case. However, as detailed above and below, an insurer's failure to post a bond that satisfies the full judgment may give rise to extracontractual liability.⁷³ As such, it is recommended that insurers *always* pay to supersede the full amount of a judgment, lest parties suffer consequences that can be easily mitigated.

7. WHAT HAPPENS IF THE JURY VERDICT EXCEEDS POLICY LIMITS?

It depends. It is axiomatic that liability insurers owe their insureds a common law and statutory duty to accept settlement offers when liability is reasonably clear, and damages are reasonably likely to exceed policy limits.⁷⁴ Additionally, Texas law requires insurers to conduct reasonable investigations of all claims, to not misrepresent facts or policy provisions when communicating with insureds, and to not deny or delay payment or settlement without a reasonable basis.⁷⁵ Accordingly, if the jury returns an excess verdict, and the excess verdict is the proximate result of an insurer's breach of common law

or statutory duties owed to its insured, then such verdict could give rise to extra-contractual liability exposure.⁷⁶

This is not to say, however, that an excess verdict in and of itself automatically creates extra-contractual liability for an insurer. As noted above, it is the entry of a judgment – not a verdict – that triggers an insured’s legal duty to pay damages.⁷⁷ Indeed, an excess verdict could be set aside by the trial court, or a motion for JNOV could be granted, or the trial court might otherwise grant a new trial, thereby nullifying the excess verdict altogether.⁷⁸ Alternatively, even if an excess verdict is reduced to final judgment at the trial court, the insurer could pay to supersede the full amount of the judgment, and the judgment then can be reversed, vacated, or modified on appeal.⁷⁹ As such, it is possible for an insured to suffer no damages from the rendition of an excess verdict or judgment.

But as noted further below, some Texas courts have recognized that an insured can suffer damages from the rendition of an excess judgment, or from insurer conduct that contributed to causing an excess judgment, even if the judgment is ultimately reversed, vacated, or modified.⁸⁰ Moreover, Texas law has left open the possibility that an insurer’s conduct may result in independent tort liability.⁸¹ Therefore, even if an excess judgment does not ultimately stand on appeal, the mere fact of an excess verdict or judgment can expose insurers to extracontractual liability.

Whether an insured has a cognizable claim for damages is highly dependent on the facts of the case. Texas insurance lawyers must take care to advise their clients to proceed with caution and prudence under such circumstances. Rushing to action may result in your client exposing itself to significantly great extracontractual liability, or in your client failing to assert the strongest potential claim for extracontractual damages. Alternatively, waiting to assess the facts giving rise to the rendition of the excess verdict may allow your client to insulate itself from exposure, or enable it to develop a devastating extracontractual damages case.

8. CAN AN INSURED SUFFER DAMAGES WHILE THE APPEAL IS PENDING?

Potentially, yes. As noted above, if an insurer fails to supersede a judgment, then the insured’s legal obligation to pay damages is triggered by the execution of the judgment, even if the insured appeals that judgment.⁸² Therefore, if the insurer fails to supersede the judgment, then the insured will be forced to pay out-of-pocket to either (a) supersede the judgment; or (b) pay the judgment outright. Depending on the policy language, failure to indemnify such costs may entitle the insured to sue for contractual and extracontractual damages.

Additionally, an insured may suffer damages from an insurer’s breach of common law and statutory duties that proximately caused an excess judgment, even if the judgment has been superseded, and even, in certain cases, when the judgment is reversed. Traditionally, Texas courts have held that “[t]he injury producing event [for claims against insurers] is the underlying judgment in excess of policy limits.”⁸³ Thus, most courts applying Texas law hold “[a] *Stowers* cause of action does not accrue until judgment in the underlying case becomes final.”⁸⁴

But since the Texas Supreme Court’s opinion in *Menchaca*, some Texas courts have recognize that an insurer’s liability for breach of common law and statutory duties is independent of its *Stowers* liability, and, as such, have allowed insureds to prosecute claims for independent damages, even when there is not an excess judgment pending against the insured.⁸⁵

Indeed, this makes sense. Even if the judgment is superseded, the insured is still legally obligated to pay damages to the claimant – that obligation is merely stayed pending final resolution of the appeal. As such, insureds must still carry the judgment on their financial statements, or otherwise disclose the judgment to counterparties in financial transactions. To the extent that the excess verdict or judgment impairs or inhibits an insured’s financial opportunities (e.g., increased difficulty in obtaining loans or credit; increased interest rate; deal negotiations falling through, etc.), it could result in cognizable damages attributable to the insurer’s conduct.

Accordingly, Texas insurance practitioners must pay close attention to damages claims that may arise after the entry of judgment, and scrutinize whether to assert such claims on behalf of an insured, or whether to alert an insurer that such claims could succeed under Texas law.

9. WHEN CAN AN INSURED SUE ITS INSURER(S) FOR EXTRA-CONTRACTUAL LIABILITY OR “BAD FAITH”?

As soon as a verdict is rendered. Texas courts are clear that a plaintiff “need not wait until all appeals have ended to sue” its insurer for extracontractual claims.⁸⁶

This derives from basic principles underlying the ripeness doctrine. Under Texas law, a case is not ripe for adjudication if an alleged injury “depends on contingent or hypothetical facts, or upon events that have not yet come to pass.”⁸⁷

In the extracontractual liability context, once an excess verdict is rendered, the risk of injury is no longer “abstract,” “contingent,” or “hypothetical.”⁸⁸ Rather, the verdict itself is sufficient evidence that there is an immi-

nent danger that an insured will be required to pay damages (*i.e.*, suffer legal injury) attributable to the insurer's conduct.

This is not to say that a bad faith case should always proceed to trial while the underlying case remains pending on appeal. Indeed, practical difficulties may arise if the insured tries to prosecute a damages model that is subject to change once the appellate court finishes its review. It is for this reason that courts will often stay extra-contractual liability cases pending resolution of the underlying lawsuit (*i.e.*, waiting until there is a final, enforceable judgment). However, the fact that judicial economy may favor staying a bad faith case does not mean that such claims should be dismissed if asserted before a final, enforceable judgment is entered in the underlying case. Rather, the insured as the true plaintiff is entitled to secure its preferred jurisdiction and venue to prosecute its extracontractual claims, should it ever become necessary for it to do so.

10. WHAT HAPPENS IF A JUDGMENT IS REVERSED, VACATED, OR MODIFIED ON APPEAL?

It depends. As noted above, an insurer's general duty to indemnify is contingent upon the insured facing a legal obligation to pay damages.⁸⁹ The corollary to this rule is if the insured no longer has a legal obligation to pay damages, then the insurer's indemnity obligation are no longer be triggered. As such, if a judgment against an insured is reversed on appeal, then the insured will no longer be responsible for paying damages, thereby eliminating the insurer's present obligation to indemnify. However, if the appellate court's ruling results in anything other than a complete reversal and rendering of judgment in the insured's favor, then the insurer's duty to defend and indemnify remains, subject to other considerations that may present, depending on how circumstances developed during the appeal.

Endnotes

¹ U.S. CONST. AMEND. VII; TEX. CONST. art. I, § 15.

² ISO Form CG 00 01 04 13 at 1.

³ See *In re USAA Gen. Indem. Co.*, 629 S.W.3d 878, 884-85 (Tex. 2021) (“A jury announces its decision with its verdict, but the resulting judgment, *not the verdict*, confers enforceable legal rights.”) (emphasis added).

⁴ *Id.* (citing TEX. R. CIV. P. 301 (“[U]pon motion and reasonable notice the court may render judgment *non obstante veredicto* if a directed verdict would have been proper, and provided further that the court may, upon like motion and notice, disregard any jury finding on a question that has no support in the evidence.”); TEX. R. CIV. P. 320).

⁵ See *Boy Scouts of Am. v. Nat’l Union Fire Ins. Co. of Pittsburgh, Pa.*, 2016 WL 495599 at *3-4 (N.D. Tex. Feb. 8, 2016) (granting dismissal of declaratory judgment action because “...an insurer’s duty to indemnify...present[s] an actual controversy only ‘after the underlying suit has been resolved.’”) (citing *Collier v. Allstate Cnty. Mut. Ins. Co.*, 64 S.W.3d 54, 62 (Tex. App.—Fort Worth 2001, no pet.)); *Coregis Ins. Co. v. Sch. Bd. of Allen Parish*, No. 07-30844, 2008 WL 2325632, at *2-3 (5th Cir. Jun. 6, 2008) (Texas law requires that after the district court concludes that...the indemnity issue is nonjusticiable pending resolution of the liability suit) (citing *Farmers Tex. Cnty. Mut. Ins. Co. v. Griffin*, 955 S.W.2d 81, 84 (Tex. 1997)); *Gilbane Bldg. Co. v. Admiral Ins. Co.*, 664 F.3d 589, 601 (5th Cir. 2011) (citing *Pine Oak Builders, Inc. v. Great Am. Lloyds Ins. Co.*, 279 S.W.3d 650, 656 (Tex. 2009)) (holding that the duty to indemnify is controlled by the facts proven in underlying suit); *Northfield Ins. Co. v. Loving Home Care, Inc.*, 373 F.3d 523, 529 (5th Cir. 2004) (citing *Griffin*, 955 S.W.2d at 84).

⁶ *Id.*

⁷ *Infra*, §§ 6 – 9.

⁸ See *Jack B. Anglin Co., Inc. v. Tipps*, 842 S.W.2d 266, 272 (Tex. 1992).

⁹ See *Scurlock Oil Co. v. Smithwick*, 724 S.W.2d 1, 6 (“[A] judgment is final for the purposes of issue and claim preclusion despite the taking of an appeal unless what is called an appeal actually consists of a trial de novo”).

¹⁰ *Ziemian v. TX Arlington Oaks Apartments, Ltd.*, 233 S.W.3d 548, 557 (Tex. App.—Dallas 2007, pet. stricken) (“...[A] judgment can be final in the sense that execution will issue in the absence of a supersedeas bond.”) (citing *Smith v. Tex. Farmers Ins. Co.*, 82 S.W.3d 580, 585 (Tex. App.—San Antonio 2002, pet. denied)).

¹¹ *Id.*; *Street v. Honorable Second Court of Appeals*, 756 S.W.2d 299, 301 (Tex. 1988) (discussing Texas law’s use of “final judgment” in different contexts as outlined above) (citing

McWilliams v. McWilliams, 531 S.W.2d 392, 393-94 (Tex. Civ. App.—Houston [14th Dist.] 1975, no writ); *cf.* TEX. R. APP. P. 24.1(f) (“Enforcement of a judgment must be suspended if the judgment is superseded”).

¹² ISO Form CG 00 01 04 13 at 1 (conditioning insurer’s duty to pay “sums” on an insured’s behalf – *i.e.*, indemnify – on the insured “becom[ing] legally obligated to pay...damages.”).

¹³ *Infra*; see also *Ziemian*, 233 S.W.3d at 557; *Street*, 756 S.W.2d at 301.

¹⁴ *Id.*

¹⁵ *Infra* § 9.

¹⁶ The Author readily acknowledges that many Texas lawyers are far more skilled in this area of the law than he is and refers the readers of this article to other published works discussing post-trial motion practice and error preservation. Indeed, the Author relied on several such works in preparing this paper and incorporated their analysis herein for the reader’s benefit (in some cases, verbatim), including:

* K. Keller, “After the Verdict: What Do I Do Now,” 28th Annual Labor and Employment Law Institute CLE (Aug. 25-26, 2017).

* R. Roach, “Post-Verdict Motions” (Sept. 18, 2003).
K. Dubose, “Preservation of Error and Avoidance of Waiver in Post-Trial Motions,” 2nd Annual Conference on Techniques for Handling Civil Appeals in State and Federal Court (Jun. 4-5, 1992).

¹⁷ TEX. R. CIV. P. 305.

¹⁸ TEX. R. CIV. P. 300.

¹⁹ See *Litton Indus. Prods., Inc. v. Gammage*, 668 S.W.2d 319, 322 (Tex. 1984); but see also *First National Bank of Beeville v. Fotjik*, 775 S.W.2d 632, 633 (Tex. 1989) (party did not waive error when it stated in its motion for entry of judgment that it did not disagree with jury’s verdict and alerted court that it felt verdict contained fatal defect that required new trial).

²⁰ See *Stewart & Stevenson Servs., Inc. v. Enserve, Inc.*, 719 S.W.2d 337 (Tex. App.—Houston [14th Dist.] 1986, writ ref’d n.r.e.) (ruling that sufficient challenges are waived by filing of a motion for entry, but that charge error was not); *cf.* *Cas v. Marathon Ref. Co.*, 896 S.W.2d 388, 389-91 (Tex. App.—Houston [1st Dist.] 1995, writ denied) (ruling that filing motion for entry preserves nothing for further appellate review).

²¹ TEX. R. CIV. P. 301.

²² *Id.*

²³ *Spiller v. Lyons*, 737 S.W.2d 29 (Tex. App.—Houston [14th Dist.] 1987, no writ) (motion for JNOV may be filed any time after judgment as long as trial court still has plenary power); but see *Commonwealth Lloyd’s Ins. Co. v. Thomas*, 825 S.W.2d 135, 141 (Tex. App.—Dallas 1992, judgment vacated

by agr., 843 S.W.2d 486 (Tex. 1993) (motion for JNOV must be filed within the deadline outlined in Rule 329(b)). Accordingly, motions for JNOV should be filed within thirty days of when the judgment is signed. *Id.*

²⁴ *Tiller v. McLure*, 121 S.W.3d 709, 713 (Tex. 2003); *John Masek Corp. v. Davis*, 848 S.W.2d 170, 173-74 (Tex. App.—Houston [1st Dist.] 1992, writ denied); *City of Brownsville v. Alvarado*, 897 S.W.2d 750, 752 (Tex. 1995). But a motion for JNOV is not always the proper means to challenge a verdict. A motion for JNOV is only proper if “a directed verdict would have been proper” (*i.e.*, the evidence conclusively demonstrates that no other verdict could be rendered). TEX. R. CIV. P. 301; *Dodd v. Tex. Farm Prods. Co.*, 576 S.W.2d 812, 815 (Tex. 1979); *Bywaters v. Gannon*, 686 S.W.2d 593, 595 (Tex. 1985).

²⁵ *See Aero Energy, Inc. v. Circle Drilling Co.*, 699 S.W.2d 821, 822-23 (Tex. 1985); *Tiller*, 121 S.W.3d at 713; *John Masek*, 848 S.W.2d at 173-74; *City of Brownsville*, 897 S.W.2d at 752; *Holland v. Wal-Mart Stores, Inc.*, 1 S.W.3d 91, 94-95 (Tex. 1999).

²⁶ *City of Keller v. Wilson*, 168 S.W.3d 802, 827 (Tex. 2005).

²⁷ *ARCO v. Misty Prods., Inc.*, 820 S.W.2d 414, 420-21 (Tex. App.—Houston [14th Dist.] 1991, writ denied).

²⁸ TEX. R. CIV. P. 320.

²⁹ *See Mushinski v. Mushinski*, 621 S.W.2d 669, 670-71 (Tex. Civ. App.—Waco 1981, no writ).

³⁰ *Smith v. Brock*, 514 S.W.2d 140, 142 (Tex. Civ. App.—Texarkana 1974, no writ).

³¹ TEX. R. CIV. P. 321, 322; *Ramey v. Collagen Corp.*, 821 S.W.2d 208, 210-11 (Tex. Civ. App.—Houston [14th Dist.] 1991, writ denied); *D/FW Commercial Roofing Co. v. Mehra*, 854 S.W.2d 182, 189 (Tex. App.—Dallas 1993, no writ).

³² TEX. R. CIV. P. 324(b).

³³ *Id.*

³⁴ TEX. R. CIV. P. 329(a).

³⁵ TEX. R. CIV. P. 324.

³⁶ TEX. R. APP. P. 26.1.

³⁷ *In re Columbia Med. Ctr. Of Las Colinas*, 290 S.W.3d 204, 213 (Tex. 2009).

³⁸ *In re United Scaffolding, Inc.*, 377 S.W.3d 685, 688-89 (Tex. 2012).

³⁹ *In re Salinas*, 2010 WL 196887 (Tex. App.—Corpus Christi Jan. 20, 2010, no pet.).

⁴⁰ TEX. R. CIV. P. 315; *Snoke v. Republic Underwriters Ins. Co.*, 770 S.W.2d 777 (Tex. 1989).

⁴¹ *Id.*

⁴² *See* TEX. R. APP. P. 46.2.

⁴³ TEX. R. CIV. P. 316.

⁴⁴ *Cockrell v. Estevez*, 737 S.W.2d 138, 140 (Tex. App.—San Antonio 1987, no writ).

⁴⁵ *Hutcherson v. Lawrence*, 673 S.W.2d 947, 948-49 (Tex. App.—Tyler 1984, no writ).

⁴⁶ *Mathes v. Kelton*, 565 S.W.2d 78, 81 (Tex. Civ. App.—Amarillo 1977), *aff'd* 569 S.W.2d 876 (1978).

⁴⁷ *See* TEX. R. CIV. P. 301a(1), 329b.

⁴⁸ TEX. R. CIV. P. 329b(g).

⁴⁹ TEX. R. CIV. P. 329b.

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² *See Garza v. Serrato*, 671 S.W.2d 713, 714 (Tex. App.—San Antonio 1984, writ ref'd n.r.e.); *P.V. Intern. V. Turner, Mason, and Solomon*, 700 S.W.2d 21, 22-23 (Tex. App.—Dallas 1985, no writ).

⁵³ *See N. Cnty. Mut. Ins. Co. v. Davalos*, 140 S.W.3d 685, 688 (Tex. 2004).

⁵⁴ *Id.*

⁵⁵ *Id.* at 688-89.

⁵⁶ *Id.*

⁵⁷ *Partain v. Mid-Continent Specialty Ins. Servs., Inc.*, 838 F. Supp. 2d 547, 566-67 (S.D. Tex. 2012); *RX.com v. Hartford Fire Ins. Co.*, 426 F. Supp.2d 546, 559-60 (S.D. Tex. 2006); *Hous. Auth. Of the City of Dallas, Tex. v. Northland Ins. Co.*, 333 F. Supp. 2d 595, 601 (N.D. Tex. 2004).

⁵⁸ *Davalos*, 140 S.W. at 689; *Unauthorized Practice of Law Comm. v. Am. Home Assur. Co.*, 261 S.W.3d 24, 40 (Tex. 2008).

⁵⁹ *Id.*

⁶⁰ *Monroe Guar. Ins. Co. v. BITCO Gen. Ins. Co.*, 640 S.W.3d 195, 199 (Tex. 2022) (citing *GuideOne Elite Ins. Co. v. Fielder Rd. Baptist Church*, 197 S.W.3d 305, 308 (Tex. 2006)).

⁶¹ *Zurich Am. Ins. Co. v. Nokia, Inc.*, 268 S.W.3d 487, 491 (Tex. 2008); *see also Monroe Guar. Ins. Co.*, 640 S.W.3d at 203 (citing *Heyden Newport Chem Corp. v. S. Gen. Ins. Co.*, 387 S.W.2d 22, 24 (Tex. 1965)) (when ultimately deciding whether an insurer owed a duty to defend, doubts should be resolved in the insured's favor).

⁶² *See Associated Auto. Inc. v. Acceptance Indem. Ins. Co.*, 705 F. Supp. 2d 714, 723-24 (S.D. Tex. 2010) (“Neither party located any Texas case law that addresses this issue. Nor has the Court’s own research revealed any such authority.”).

⁶³ *See* ISO CG 00 01 04 13 at 1 (“Our right and duty to defend ends when we have used up the applicable limit of insurance in the payment of judgments...”).

⁶⁴ See *Nat'l Union Fire Ins. Co. v. Hudson Energy Co.*, 811 S.W.2d 552, 555 (Tex. 1991).

⁶⁵ *Associated Auto. Inc.*, 705 F. Supp. 2d at 725 (citing *Gibbons-Markey v. Tex. Med. Liab. Tr.*, 163 Fed. App'x 342, 346 (5th Cir. 2006)); see also *WFG Nat'l Title Ins. Co. v. Pinnacle Premier Prop., Inc.*, 2014 WL 12537168, at *7 (S.D. Tex. Jul. 11, 2014) (citing *Associated Auto. Inc.*) (holding same); *R.M. Personnel v. Liberty Mutal Fire Ins. Co.*, 2018 WL 935397, at *5 (W.D. Tex. Feb. 16, 2018) (same).

⁶⁶ See *Associated Automotive Inc.*, 705 F. Supp. 2d at 724 (citing *Chrestman v. U.S. Fidelity & Guar. Co.*, 511 F.2d 129, 130 (5th Cir.1975) (Mississippi law) (stating that a plaintiff insured raising a duty to appeal claim against an insurer would have to show, at the very least, that there were reasonable grounds for the appeal); *Cathay Mortuary (Wah Sang) Inc. v. United Pacific Ins. Co.*, 582 F. Supp. 650, 657 (N.D. Cal. 1984) (California law) (recognizing “a general consensus that an insurer is obliged to pursue an appeal on behalf of its insured where there are reasonable grounds for appeal.”); *MedMarc Cas. Ins. Co. v. Forest Healthcare, Inc.*, 359 Ark. 495, 199 S.W.3d 58, 62 (2004) (citing ALLAN D. WINDT, *INSURANCE CLAIMS & DISPUTES* § 4:17 (4th ed. 2001) (stating that an insurer is obligated to appeal a judgment against its insured only when there are reasonable grounds to believe that insured's interest would be furthered by the appeal, and collecting cases)); *Sanchez ex rel. Sanchez v. Kirby*, 131 N.M. 565, 40 P.3d 1009, 1011–12 (N.M. Ct. App. 2001) (“The general rule appears to be that an insurer has a fiduciary duty to file and prosecute an appeal, absent a policy provision to the contrary, where there are reasonable grounds to believe substantial interests of the insured may be served or protected thereby.”); *Davis v. Allstate Ins. Co.*, 434 Mass. 174, 747 N.E. 2d 141, 146 (2001) (recognizing “established rule that an insurer's duty to defend generally the encompasses an obligation to appeal from an adverse judgment against its insured, but only if reasonable grounds exist to believe that the insured's interest might be served by the appeal.”); *Chatoney v. Safeway Ins. Co.*, 801 So. 2d 448, 450–51 (La. Ct. App. 2001) (“[An] insurer's obligation to defend includes the duty to appeal judgment adverse to the insured where there appears reasonable grounds for taking an appeal.”); *Delmonte v. State Farm Fire and Cas. Co.*, 90 Hawai'i 39, 975 P.2d 1159, 1168–69 (1999) (duty to defend includes a duty to appeal where there are reasonable grounds for the appeal unless the insurance contract expressly provides to the contrary); *Ursprung v. Safeco Ins. Co. of Am.*, 497 S.W.2d 726, 730–31 (Ky. 1973) (“...[W]e have concluded that the contractual obligation to defend carries with it an obligation to prosecute an appeal from a judgment against an insured where there are reasonable grounds for appeal.”)

⁶⁷ See TEX. R. CIV. P. 627.

⁶⁸ *Id.*

⁶⁹ *Id.*; TEX. R. APP. P. 24.1 (“Enforcement of a judgment must be suspended if the judgment is superseded.”)

⁷⁰ *Id.*

⁷¹ *Supra*.

⁷² *Id.*

⁷³ *Infra* § 8.

⁷⁴ TEX. INS. CODE § 541.060(a); *G.A. Stowers Furniture Co. v. Am. Indem. Co.*, 15 S.W.2d 544 (Tex. 1929); *Am. Physicians Ins. Exch. v. Garcia*, 876 S.W.2d 842, 849 (Tex. 1994); *Rocor Int'l, Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, 77 S.W.3d 253, 262 (Tex. 2002).

⁷⁵ TEX. INS. CODE § 541.060(a); *Universal Life Ins. Co. v. Giles*, 950 S.W.2d 48, 50–51 (Tex. 1997) (“An insurer breaches its duty of good faith and fair dealing when the insurer had no reasonable basis for denying or delaying payment of [a] claim, and [it] knew or should have known that fact.”).

⁷⁶ *Supra*; *infra* § 8.

⁷⁷ *Supra* § 1.

⁷⁸ *Supra* § 3.

⁷⁹ *Id.* §§ 3 – 5.

⁸⁰ *Infra* § 8.

⁸¹ See *Republic Ins. Co. v. Stoker*, 903 S.W.2d 338, 341 (Tex. 1995).

⁸² *Supra* §§ 1, 2, 6.

⁸³ *Murray v. San Jacinto Agency*, 800 S.W.2d 826, 829 (Tex. 1991); see also *Linkenhoger v. Am. Fidelity & Cas. Co.*, 260 S.W.2d 884, 887 (Tex. 1953) (concluding the insured “could not have maintained this present suit until such time as his liability and the extent thereof had been determined by a final judgment in the former case. Until then...the tort was not complete.”).

⁸⁴ *Street*, 756 S.W.2d at 301; see also, e.g., *In re Davis*, 253 F.3d 807, 809 (5th Cir. 2001); *One Beacon Ins. Co. v. T. Wade Welch & Assoc.* 2012WL 2403500, at *5 (S.D. Tex. Jun. 25, 2012).

⁸⁵ See, e.g., *Medallion Transp. & Logistics, LLC v. Granite State Ins. Co.*, 2018 WL 3249708, at *4 (E.D. Tex. Jun. 27, 2018) (allowing insured to prosecute extracontractual claims against insurer even though the insurer had bonded excess judgment, reversed on appeal, and then settled the case); *Liberty Ins. Underwriters, Inc. v. Pay & Save, Inc.*, 2020 WL 6122551, at *5 (N.D. Tex. Sept. 8, 2020) (finding insured could assert ripe extracontractual claims, even though the insurer had superseded the excess judgment and was prosecuting appeal to overturn the verdict) (citing *Medallion Transp.*); see also *USAA Tex. Lloyds Co. v. Menchaca*, 545 S.W.3d 479 (Tex. 2018).

⁸⁶ See *Archer v. Med. Protective Co. of Ft. Wayne, Ind.*, 197 S.W.3d 422, 426 (Tex. App.—Amarillo 2006, pet.

denied); *see also* *Bramlett v. Med. Protective Co. of Ft. Wayne, Ind.*, 2013 WL 796725, at *6 (N.D. Tex. Mar. 5, 2013) (Fitzwater, C.J.) (citing *Archer*, 197 S.W.3d at 426) (“Texas law allows an insured to bring a *Stowers* action as soon as there is a jury verdict exceeding policy limits.”).

⁸⁷ *See Arnold & Itkin, LLP v. Dominguez*, 501 S.W.3d 214, 221 (Tex. App.—Houston [1st Dist.] 2016, no pet.) (citing *Waco Indep. Sch. Dist. v. Gibson*, 22 S.W.3d 849, 851-52 (Tex. 2000); *Patterson v. Planned Parenthood of Houston & Se. Tex., Inc.*, 971 S.W.2d 439, 442 (Tex. 1998)); *see also Mayfield v. Tex.*, 206 F. Supp. 2d 820, 823-24 (E.D. Tex. 2001) (“A claim is not ripe for adjudication if it rests upon contingent future events that may not occur as anticipated, or indeed may not occur at all.”).

⁸⁸ *See Ohio Forestry Ass’n, Inc. v. Sierra Club*, 523 U.S. 726, 733-35 (noting that ripeness doctrine is designed “to prevent the courts, through avoidance of premature adjudication, from entangling themselves in abstract disagreements...”); (quoting *Abbott Labs. v. Gardner*, 387 U.S. 136, 148-49 (1967)).

⁸⁹ *Supra* § 1; *see also* CG 00 01 04 13 at 1.





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