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Fifth Circuit: CGL's "Contractual Liability" Exclusion Broadly Applies to Exclude Coverage in Construction Defect Cases Where the Damages Alleged Are To the Insured's Contracted Work

As we reported in our June 11, 2010 Client Alert, the Texas Supreme Court in *Gilbert Texas Construction v. Underwriters at Lloyds, 327 S.W.3d 118 (Tex. 2010)* rejected the policyholder's argument that the CGL policy's "contractual liability" exclusion only applied to situations where the insured had contractually assumed someone else's liability in a contract and held, instead, that the exclusion applied even to the insured's own liability to the extent that such liability was contract-based. We cautioned though that it was unclear whether *Gilbert* might be limited to its somewhat unusual facts involving an insured contractor that agreed, in its contract, to remedy any damage caused by its construction activities to adjoining third-party property. However, as reported in our Client Alert of April 28, 2011, a federal district judge in Corpus Christi concluded the following year in *Ewing Construction v. Amerisure* that *Gilbert* was not so limited and the exclusion negated coverage for the insured's defective tennis court construction work even though the pleadings alleged negligence and the completed work involved was performed by subcontractors, and thus was outside of the standard "insured's work" exclusion. We again cautioned, however, that it remained to be seen if the Fifth Circuit would agree with the *Ewing* district court's broad reading of *Gilbert*.

To the surprise of many, on June 15, 2012, a 2-1 panel majority of the Fifth Circuit agreed with the district court's holding and reasoning in *Ewing*. *Ewing Construction v. Amerisure Ins. Co.,* 2012 WL 2161134 (5th Cir. June 15, 2012). Judge Davis, in a vigorous dissent, pointed out that the Texas Supreme Court's *Lamar Homes* opinion held that construction defects would generally be treated as "property damage" caused by an "occurrence" with the CGL's "business risk" exclusions (j, l and m) then serving to eliminate coverage for large parts of the defective workmanship itself. The majority opinion nonetheless held that *if the only damages alleged are to the work that was the subject of the insured's construction contract*, the "contractual liability" exclusion separately operates to negate coverage. And the majority reached this result without any need to go through the usual "business risk" exclusion analysis of "that particular part of property," completed versus uncompleted work, or subcontractor involvement.

Additionally, even though the Texas Supreme Court in *Lamar Homes* specifically rejected the use of the "economic loss rule" as a rule of policy construction, the Fifth Circuit's majority opinion quoted the usual "economic loss rule" test language and held that the fact that there were also negligence claims alleged against Ewing did not trigger a duty to defend since the source of liability was a contract and the only damages alleged were to the subject of the contract, *i.e.,* the tennis courts.

Finally, the majority acknowledged that the dissent had raised a "troubling concern" that such a broad construction of *Gilbert* and the "contractual liability" exclusion necessarily meant that the "contractual liability" exclusion would make the "insured's work" exclusion (and, potentially, the other "business risk" exclusions) largely superfluous. But the majority held that any overlap between the contractual liability exclusion and the "business risk" exclusions was not a good

reason to ignore what *Gilbert* seemed to clearly hold. The majority noted that *Gilbert* required this holding "regardless of our misgivings."

A dissenting opinion is one of the bases upon which the Fifth Circuit can grant motions for rehearing by the entire Fifth Circuit slate of judges, *i.e*., *en banc.* Thus, Judge Davis' dissent may invite a motion for rehearing *en banc* by Ewing such that this recent opinion is not the last word. Judge Davis also stated that he would certify the issue involved to the Texas Supreme Court for decision. Thus, we would not be surprised if Ewing files a motion for rehearing en banc and urges the full court to certify the question to the Texas Supreme Court.

Practical Pointers—This decision is obviously very significant and favorable to insurers. It is bad for contractors, especially general contractors and homebuilders, as typically the entire project or home is the subject matter of the contractor's and/or builder's contract. However, it should not be read even more broadly than it actually is. The majority opinion was very careful to make clear that its holding was rooted in the fact that the only damages alleged were to the tennis courts themselves, *i.e.*, the subject matter of the construction contract. And the majority explicitly reversed the district court's ruling on the duty to indemnify by pointing out that it was possible that there would be evidence of damage to things other than the tennis courts presented at trial. Thus, even under the majority's broad reading of the contractual liability exclusion, if the pleadings against the insured contractor allege that the contractor's defective work caused damage to something outside of the scope of the contracted work, then this *Ewing* decision does not support denial of defense based simply on the "contractual liability" exclusion. Instead, in such cases, the required analysis under the other "business risk" exclusions remains relevant.

Carriers should immediately review pending construction defect claims to make sure that they have properly reserved rights under the "contractual liability" exclusion. If not, a supplemental reservation-of-rights letter may be in order depending on the circumstances.

If this decision withstands scrutiny on a motion for rehearing and/or if the Texas Supreme Court does not repudiate it in a subsequent case, then the effect will likely be that for general contractors and builders, there is no coverage or duty to defend construction defect claims under the standard ISO form CGL policy unless the defective construction is alleged to have caused consequential damage to something other than the project/home. And this is true irrespective of whether negligence is alleged, and whether or not the work was complete, and even though subcontractors were involved. As a result, policyholders with bargaining leverage may want to insist that their policies be endorsed to specifically narrow the scope of the standard ISO "contractual liability" exclusion.

If you wish to discuss any insurance-related issues or needs, please feel free to contact Schubert & Evans, P.C. at 214.744.4400 or visit our website at www.schubertevans.com.