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NEW TEXAS COVERAGE CASE ALERT – December 22, 2010

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CGL Carrier Had No Duty to Defend Builder in Mandatory State Sponsored Inspection Process ("SIRP") Under Texas Residential Construction Act Since it is Not a "Suit" Under Standard CGL Policy Definition; At Least Not Unless Carrier Has Consented to the SIRP and is Notified of It

As anyone handling Texas residential construction defect claims knows, under the Texas Residential Construction Act, before any suit for a "construction defect" can be filed, the homeowner or builder must first comply with the Act's state-sponsored inspection and dispute resolution process ("SIRP") by making a SIRP request for inspection by a neutral third-party state-licensed inspector who then issues a recommendation. The inspector's recommendation then serves as a rebuttable presumption on the existence or not of a construction defect and the reasonable repair plan needed. See, Tex. Prop. Code Secs. 428.001-428.005. Since the SIRP process is a mandatory prerequisite to any suit by the homeowner against the builder, the issue thus arises as to whether SIRP triggers a defense obligation under the standard CGL policy. The CGL language, typically, defines "suit" as including not only a "civil proceeding" in which potentially covered damages are alleged, but also "any other alternative dispute resolution proceeding in which such damages are claimed and to which the insured submits with our [*i.e.,* the insurer's] consent."

This issue was recently addressed by a Texas federal district judge in *Hardesty Builders, Inc. v. Mid-Continent Cas. Co*., Civ. Action No. C-10-142 (S.D. Tex., Dec. 13, 2010). In *Hardesty*, the builder entered into a remodeling contract with the homeowners in 2004, completed the work in 2006 and the homeowners began to make complaints about the work in 2007. The homeowners filed a SIRP request with the Texas Real Estate Commission in July 2008 and the SIRP process commenced. While the builder's attorney kept the insurer generally informed, he did not send the SIRP request or any SIRP documents to the insurer. The SIRP process concluded in January 2009 with a finding of a construction defect. The insured's attorney then informed the insurer of the unfavorable SIRP findings in March 2009. Two days later, the insurer denied coverage in a phone call. The homeowners then sued the builder and the builder forwarded the suit to the carrier. In the interim, however, the builder settled the suit without the insurer's participation or approval. The insurer then denied defense and coverage for the suit. The builder sued the insurer for breach of contract, and violations of the Insurance Code and DTPA, contending that the insurer wrongfully denied defense of the SIRP proceeding and suit.

The court easily disposed of the insured's argument that the insurer had wrongfully denied defense on the lawsuit since the suit was not tendered to the carrier until after the settlement was reached. The court then addressed whether the SIRP process triggered a duty to defend as of July 2008 when the homeowners made their SIRP request.

The court held that SIRP was not a "civil proceeding" or arbitration in which damages could be awarded since under the SIRP statute the inspector cannot award damages but can only determine if a "construction defect" exists and, if so, a reasonable repair method. The court also

emphasized that SIRP was a prerequisite to a suit and not a suit itself. The court acknowledged, however, that a SIRP might fall under the standard CGL policy's "suit" definition as an "alternative dispute resolution proceeding." However, the court noted that this "other ADR" prong of the "suit" definition required that the insured get the insurer's consent before agreeing to submit to the ADR process. Here, there was no evidence that Mid-Continent had consented. Finally, the court also noted alternatively that there was no evidence that the SIRP request was ever actually tendered to the carrier.

The court's focus on whether the insurer had consented to the SIRP process is curious and potentially troublesome. Once the homeowners invoked SIRP, the process was mandatory. Neither the builder nor its insurer had any consent rights. The process simply proceeds with or without the builder's participation with obviously bad potential consequences for nonparticipation. The arbitration section of the "suit" definition recognizes that insured may be required to submit to arbitration and thus includes such mandatory arbitrations within the definition of "suit." The policy only requires insurer consent as to other non-mandatory arbitrations. Then, in the second part of the "suit" definition, the policy drafters appear to be only concerned with other voluntary ADR proceedings like mediations, settlement conferences etc., where the insurer, legitimately, should have a say as to its insured's agreement to participate or not, especially with the insurer's money involved.

PRACTICAL POINTER: The Texas SIRP process simply does not fit nicely within any of the categories of "suit" as defined in the policy. It is clearly not arbitration or a lawsuit, but yet is a mandatory ADR proceeding that will necessarily be a required precursor to any later suit. Thus, insurers have good reason to be involved in defending their insured builders in the SIRP process especially since the SIRP outcome can have significant impact on the builder's defense to the later suit or may even prevent a suit.

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.