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**“You Can’t Handle the Truth”
Pleading and Duty to Defend, a Policyholder Perspective**

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In representing the policyholder seeking a defense under a standard CGL type policy (or even the underlying plaintiff suing the policyholder in drafting pleadings designed to invoke coverage), counsel need to be familiar with several significant cases that have been handed down within the last couple of years. While the general mantra that the duty to defend is governed by the “complaint allegation” or “8 Corners” rule is longstanding, unchanged Texas law, how that general rule is applied to real life pleadings in actual suits is in a definite state of uncertainty and complication.

The hypo that this seminar is built around is a construction defect suit. Perhaps nowhere are the boundaries of the “8 Corners” rule and possible exceptions to it illustrated better and more frequently than in the construction defect arena. This is due to several factors that are frequently present in the typical construction defect claim:

- Often, identifying a fixed specific date when the damage occurred is difficult, or there are multiple dates and yet those dates may be of little importance to the liability case, and thus unpleaded, yet are critical to identifying the applicable coverage year(s);
- Whereas the standard CGL policy attempts to carve out large parts of the typical property damage involved in a construction defect case based on things like whether work was completed or not, whether subs were involved or not, and the precise nature of the damage producing event or conduct, those details, critical to coverage, are rarely all nicely set forth in the typical liability pleading.

A REVIEW OF THE HYPOTHETICAL FACTS/PLEADINGS

The case hypothetical, a construction defect claim, is a fairly typical scenario. In this connection, it is to be assumed under the hypothetical that the pleadings against the insured:

- Reveal only the date of the construction contract and a later date on which the water damages and related roof defects were discovered but are otherwise silent as to the date(s) on which the damage actually occurred;
- Are silent as to whether any such damage occurred while the insured general contractor was still working on the project or, instead, all occurred after the insured’s work had been completed;
- Are silent on whether the insured used a subcontractor to perform the allegedly defective roof work involved;
- Initially named as the only defendant “Insured Builders, Inc.”, the named insured under the policies at issue, but were subsequently amended to also add “Insured Builders, Inc. d/b/a Texas Insured Builders, Inc.” when it was discovered by Plaintiff counsel that during the course of the original construction work, Insured Builders, Inc. was legally converted to Texas Insured Builders, Inc.

- Alleged claims based on negligence, breach of contract and breach of warranty.

Otherwise, it is to be assumed under the hypothetical that the pleadings are silent beyond merely alleging that at some unspecified point in time after the date of the construction contract, the Defendants constructed a faulty roof that resulted in leaks apparently discovered at the later identified discovery date. Nothing is revealed about when the leaks actually started to occur, when the work was completed in relation to same, or who actually did the work complained of (insured contractor or a subcontractor).

THE “COMPLAINT ALLEGATION RULE” A/K/A “8 CORNERS RULE”

The starting point on duty to defend issues, of course, is the “complaint allegation” or “8 corners” rule. This well known rule is fairly easy to state.

THE GENERAL BROAD RULE: Under the rule, “an insurer’s duty to defend is determined by the third-party plaintiff’s pleadings, considered in light of the policy provisions, without regard to the truth or falsity of those allegations.” *Zurich American Ins. Co. v. Nokia Inc.*, 268 S.W.3d 487, 491 (Tex. 2008); *Guide One Elite Ins. Co. v. Fielder Road Baptist Church*, 197 S.W. 3d 305, 308 (Tex. 2006). Another formulation of the rule is as follows: “Under this rule, courts compare the words of the insurance policy with the allegations of the Plaintiff’s complaint to determine whether any claim asserted in the pleading is potentially within the policy’s coverage.” *National Union Fire Ins. Co. v. Merchants Fast Motor Lines, Inc.*, 939 S.W.2d 139, 141 (Tex. 1997). It has its original genesis in the language of the typical liability policy stating that the insurer will defend the insured “even if the allegations are groundless, false or fraudulent.”

Applying the rule is fairly straightforward if the pleadings the in the underlying suit allege the damages complained of, their source, and their date as is usually the case when simple, discrete events result in easy to understand bodily injury or property damage claims like car accidents, explosions etc. But this fairly straightforward rule becomes more difficult to practically apply when the suit concerns claims that do not involve a simple straightforward date or discrete damage-causing event, such as construction defect claims.

But what if the allegations of the plaintiff are ambiguous or silent as to certain facts that are critical to coverage? Here, Texas courts have over the years applied two corollaries, what I will call “Subset Rules”.

SUBSET RULE NO. 1

The first Subset rule is frequently stated as follows:

If there is “doubt as to whether or not the allegations of a complaint against the insured state a cause of action within the coverage of a liability policy sufficient to compel the insurer to defend the action, such doubt will be resolved in [the] insured’s favor.”

Merchants, 939 S.W.2d at 141.

Or stated differently:

“Courts must resolve all doubts regarding the duty to defend in favor of the duty.”
Heyden Newport Chem. Corp. v. Southern Gen. Ins. Co., 387 S.W.2d 22, 26 (Tex. 1965).

Subset Rule No. 1 is very important to keep in mind if you represent the policyholder because it is a “one way street”, i.e. it will always benefit the insured, never the insurer. So, if you can bring the pleadings within the scope of Subset Rule No. 1, there will usually be duty to defend.

SUBSET RULE NO. 2.

The second frequently stated Subset rule is often stated as follows:

“We will not read facts into the petition, nor will we look outside of the petition, or imagine factual scenarios which might trigger coverage.”
Merchants, 939 S.W.2d at 142.

In contrast to Subset Rule No. 1, as lawyer for the policyholder, you must **beware of Subset Rule No. 2** because if the court views the pleadings involved as falling within Subset Rule No. 2, that can, as shown by some of the cases discussed below, lead the court to conclude that there is no duty to defend because the allegations do not sufficiently allege covered facts. **But, on its face, Subset Rule No. 2 is a “two way street” insofar as it bars imagining unpleaded factual scenarios whether such unpleaded facts are suggested by the insurer or the insured.**

As the mere quotation of the two Subset Rules reveals, the two Subset Rules appear to be somewhat contradictory. On one hand, there is a duty to defend if any claim pleaded is even potentially covered, with all doubts to be resolved in favor of the insured, but yet courts will not necessarily assume the possibility of missing facts if that would result, in the court’s eyes, in “imagining factual scenarios” that have not been pleaded. And in truth, I would submit that courts have utilized the two Subset Rules to reach a desired end result by applying one rule in some cases and the other rule in others. Thus, in representing either the insurer or insured in a duty to defend dispute, counsel should carefully examine the currently live pleading of the claimant without regard to whether the allegations are correct or not, and then compare it to the coverage of the policy with Subset Rules No. 1 and 2 in mind.

PRACTICAL APPLICATION: If the pleadings are sufficiently clear and factually complete such that assuming them to be true leads to the conclusion that the coverage of the policy is triggered, then that should be the end of the inquiry and there will be a duty to defend. If, on the other hand, because of ambiguities in the pleadings or certain key coverage facts being missing in the pleadings, the general broad rule still leaves the question in doubt, then the policyholder lawyer should argue that Subset Rule No. 1 requires that all reasonable doubts or ambiguities be resolved in favor of the insured such that there is a duty to defend. And if the

insurer's claimed coverage defense depends on some fact that the pleadings do not affirmatively allege, then the policyholder lawyer should invoke Subset Rule No. 2 and argue that the insurer's position requires reading unpleaded facts into the pleadings and imagining factual scenarios that the pleadings do not contain.

If going through this threshold analysis still leaves the duty to defend unresolved, then the issue will turn on whether extrinsic evidence can be considered to fill in the key missing coverage-important facts.

WHEN CAN COURTS CONSIDER EXTRINSIC EVIDENCE?

Texas courts, historically and prior to *Guide One*, have allowed extrinsic evidence in a variety of circumstances where such evidence only went to a key coverage issue and did not touch on the merits of the liability case:

- *State Farm Fire & Cas. Co. v. Wade*, 827 S.W.2d 448 (Tex. App.—Corpus Christi 1992, writ denied)—extrinsic evidence allowed on whether boat involved in accident was being used for business purposes or not;
- *Cook v. Ohio Cas. Ins. Co.*, 418 S.W.2d 712 (Tex. Civ. App.—Texarkana 1967, no writ)—extrinsic evidence allowed on car ownership which only affected coverage;
- *Int'l Service Ins. Co. v. Boll*, 392 S.W.2d 158 (Tex. Civ. App.—Houston [1st Dist.] 1965, writ ref. n.r.e.)—extrinsic evidence allowed to show that named insured's son, who was expressly excluded from coverage on his father's policy, was the "son" alleged in the petition.

Based on these cases, the 5th Circuit has made an Erie-guess, prior to *Guide One* at least, that "the 'eight corners rule' does not prohibit reference to extrinsic evidence when the petition 'does not contain sufficient facts to enable the court to determine if coverage exists.'" *Primrose Operating Co. v. National Am. Ins. Co.*, 382 F.3d 546, 552 (5th Cir.2004); *Western Heritage Ins. Co. v. River Entertainment*, 998 F.2d 311, 313 (5th Cir. 1993); *Northfield Ins. Co. v. Loving Home Care Inc.*, 363 F.3d 523, 530-31 (5th Cir. 2004). According to the court in *Northfield*, if the Texas Supreme Court were to recognize any exception to the strict "8 corners" rule, it would be limited to situations where "it is initially impossible to discern whether coverage is potentially implicated and when the extrinsic evidence goes solely to a fundamental issue of coverage which does not overlap with the merits of or engage the truth or falsity of any facts alleged in the underlying case." *Northfield*, 363 F.3d at 531. This potential exception, as noted, only applies in limited circumstances to determine "fundamental coverage issues" involving facts that can be readily ascertained without engaging the truth or falsity of any of the allegations. *Northfeild*, 363 F.3d at 530.

Subsequent Texas Supreme Court decisions since *Northfield* have done little to shed light on whether the 5th Circuit's Erie guess in *Northfield* was correct or incorrect, although one could certainly argue that since the Texas Supreme Court has now had multiple occasions to, but has

refused to, repudiate the 5th Circuit's prediction, this suggests that there may be such a limited exception.

In *Guide One Elite Ins. Co. v. Fielder Road Baptist Church*, 197 S.W.3d 305 (Tex. 2006), in dicta, the court favorably cited *Loving Home Care's* prediction that to the extent that the Texas Supreme Court were to recognize any exception to the "8 corners" rule at all, it would be limited to situations where the evidence goes solely to a fundamental coverage issue and does not overlap the liability merits or contradict the allegations. *Guide One*, 197 S.W.3d at 308-09. The *Guide One* court hinted that a narrowly drawn exception might be appropriate in some cases. *Id.* at 310. The *Guide One* court flatly rejected extrinsic evidence, however, if it would engage the truth or falsity of any of the allegations. *Id.* at 309, 310.

Then, in *Zurich Am. Ins. Co. v. Nokia*, 268 S.W.3d 487 (Tex. 2008), in rejecting the insurer's extrinsic evidence offered to show that notwithstanding allegations that suggested that the suit was potentially seeking "bodily injury" damages, other documents filed by the plaintiff showed they were not, the court simply noted that to date it had not recognized any exception to the "8 corners rule". The court acknowledged *Guide One's* dicta about a narrow possible exception but concluded that it need not decide if such exception existed since the evidence offered by the insurer in the case before it contradicted the pleadings which suggested the possibility of "bodily injury".

Then, in *Pine Oak Builders, Inc. v. Great American Lloyds Ins. Co.*, 279 S.W.3d 650 (Tex. 2009), the court again recognized, and quoted, the language from *Guide One* that suggests that the court might recognize a limited exception to the "8 Corners Rule", *Id.* at 654. The court concluded (incorrectly I would submit, see below), however, that extrinsic evidence offered by the insured contractor to show that a subcontractor had done the defective work at issue (so as to invoke the "subcontractor exception" to the "insured's work" exclusion) touched on liability issues and thus could not be considered.

Finally, in *D.R. Horton v. Markel*, 300 S.W.3d 740 (Tex. 2009), D.R. Horton argued that extrinsic evidence on the involvement of a subcontractor in the allegedly defective work at issue should have been considered in order to determine if D.R. Horton qualified as an additional insured under the subcontractor's policy. The pleadings in the underlying suit, as in *Pine Oak*, were completely silent on the involvement of any sub. While again noting *Guide One's* suggestion of a limited exception to the "8 corners" rule, the *D.R. Horton* court expressly disclaimed addressing the issue head on since it held that the issue had been waived in the lower court. *Id.* at 743.

Thus, as of the current date, the Texas Supreme Court in multiple cases since *Northfield's* Erie guess, has somehow found a way to avoid either approving or rejecting 5th Circuit's Erie guess or otherwise squarely answer the question as to whether there are any exceptions to the "complaint allegation" rule and, if so, what are the parameters of it. We are left with the hint in *Guide One*, if one can call it that, coupled with the Court's repeated opportunity but refusal to repudiate that hint to date. Thus, the only conclusion that one can safely draw is that if there is any exception that would allow extrinsic evidence on the duty to defend question, it is a narrow

“coverage only facts” exception and the relevant coverage evidence cannot overlap or contradict the pleaded liability facts.

Even after *Guide One*, including recently, the Fifth Circuit has continued to read *Guide One* as still allowing for a limited exception to the strict “8 corners” rule where extrinsic evidence is admissible on a fundamental coverage-only issue that does not overlap the merits of the liability case. *Ooida Risk Ret. Group v. Williams*, 579 F.3d 469 (5th Cir. 2009)(where petition was silent as to whether deceased Plaintiff passenger was operating truck as a tandem driver with the driver so as to qualify as statutory employee under FMCSA, and thereby invoke coverage exclusion, extrinsic evidence allowed on that issue) ; *VRV Dev. v. Mid-Continent Cas. Co.*, 2010 WL 375499 (N.D. Tex. 2010)(citing *Ooida* and the language in *Guide One*, concluding that extrinsic evidence was admissible to determine if corporation sued but not named in the policy was an “insured” by virtue of having been a corporate successor of the named insured).

And in a very recent case, one federal court allowed the insurer to present extrinsic evidence showing that plaintiff’s injuries stemmed from an excluded assault and battery and liquor liability incident after the plaintiff amended his pleadings to conspicuously delete all of the references to the assault or alcohol that had been included in his prior pleadings. *Nautilus Ins. Co. v. Texas State Security and Patrol*, 2010 WL 3239157 (W.D.Tex. 2010). The court reasoned that under *Northfield* and the limited exception recognized in *Guide One*’s dicta, such evidence designed to “fill in the facts” did not contradict any of the allegations of the amended pleading that deleted most of the facts.

DO THE HYPO’S BROAD, NONSPECIFIC PLEADINGS ALLEGE AN “OCCURRENCE”?

For the vast majority of construction defect lawsuits, the Texas Supreme Court has now in *Lamar Homes Inc. v. Mid-Continent Cas. Co.*, 242 S.W.3d 1 (2007) clearly rejected most of the arguments that insurers and many courts, prior to *Lamar*, frequently made to find that construction defect claims did not allege any “occurrence” or “property damage” under the standard CGL definition of that term. As a result, under *Lamar*, it will be the extremely rare construction defect claim that will not satisfy the “occurrence” definition. According to the court, “[W]e conclude that allegations of unintended construction defects may constitute an ‘accident’ or ‘occurrence’ under the CGL policy and that allegations of damage to, or loss of use of, the home itself [or other structure being built] may also constitute “property damage” sufficient to trigger the duty to defend under a CGL policy.”

In so holding, the *Lamar* court specifically rejected several arguments that historically have been made by insurers and courts to assert that construction defect claims were not an “occurrence” or “property damage”:

- The policy coverage does not depend on the tort v. contract distinction or whether the “economic loss” rule applies;

- Merely because noncompliance with specifications or plans may make damages foreseeable from a tort or negligence foreseeability standpoint does not mean that damages are intentional v. accidental;
- “Occurrence” is not defined in terms of property ownership or the character of the property damaged by the act or event; rather the policy simply requires that the injury be unintended, fortuitous or accidental.

Thus, unless the pleadings in a construction defect suit omit negligence claims and instead allege that the insured contractor actually expected or intended the damages complained of, the pleadings will nearly always otherwise allege an “occurrence”. *Lamar Homes*, 242 S.W.3d at 9.

In fact, even if the pleadings do not even use the term negligence to describe the insured’s conduct, in the absence of affirmative allegations that the insured expected or intended the damages complained of, a pleading will be construed under Subset Rule No. 1 (see above) as potentially alleging an “occurrence”. *Building Specialties, Inc. v. Liberty Mutual Fire Ins. Co.*, 2010 WL 1990115, *8-9 (S.D. Tex. 2010).

PRACTICAL APPLICATION--Accordingly, in representing the insured in our hypo, clearing the “occurrence” hurdle is easy as it will be in the vast majority of construction defect cases. The hypo pleadings alleged the typical breach of contract, warranty and negligence claims generally and do not allege any intent to cause damage. The “occurrence” requirement is met under *Lamar*.

DO THESE TYPE OF BROAD, NONSPECIFIC PLEADINGS CONTAINING FEW DATES, AND NO DATE OF WHEN THE PROPERTY DAMAGE OCCURRED, ALLEGE “PROPERTY DAMAGE” OCCURRING WITHIN THE POLICY PERIOD, AS REQUIRED?

In *Don’s Building Supply Inc. v. One Beacon Ins. Co.*, 267 S.W.3d 20 (Tex. 2008), the Texas Supreme Court resolved the historical uncertainty as to the applicable property damage trigger date for the standard CGL policy wording. It rejected the oft applied manifestation rule (i.e. coverage is triggered based on the date the property damage first manifested or became apparent) and instead adopted a rule it found to be mandated by the literal policy wording, “actual injury” (i.e. coverage is triggered based on the date the property damage or injury actually occurs whether discovered, manifested or otherwise apparent then or not). Thus, for purposes of invoking a duty to defend in a typical construction defect case, there must be pleadings that allege or at least potentially allege that the “property damage” complained of occurred during the policy period.

Frequently, this date will be missing from the pleading against the insured (because it often is irrelevant to liability and only to coverage, although not if there is a limitations issue). Thus, as in the hypo, the issue will frequently be whether or not the date of “property damage occurring” can be supplied by involving Subset Rule No. 1 or via extrinsic evidence. Accordingly, the entire body of case law discussed above on the “8 corners rule” and whether there are any limited exceptions to it comes into play. And not surprisingly, there are cases

going both ways on whether a particular pleading can be read to potentially allege or cannot be read to allege property damage within the policy period.

The following cases can be used by the policyholder to argue that vague pleadings must be construed liberally (Subset Rule No. 1) to potentially allege some possible property damage within the period:

- *Gehan Homes v. Employers Mut. Cas. Co.*, 146 S.W.3d 833 (Tex. App.—Dallas 2004 pet. denied)—allegation of damages in the past but without further identification as to the time of damages did not establish as a matter of law that there was no potential damage within the policy period;
- *Nautilus Ins. Co. v. Nevco Waterproofing*, 2005 WL 3088608 (S.D. Tex. 2005)—where petition alleged only date that mold was discovered, July 5, 2001, and policy expired June 16, 2001, the liberal construction of pleadings rule (Subset Rule No. 1) obligated insurer to defend since the pleading “supports the reasonable inference that there was mold present and identifiable on or before June 16.” (Court was applying the old “manifestation” trigger date prior to *Don’s Building*).

On the other hand, some courts, applying Subset Rule No. 2 (see above) have refused to read missing dates into the pleading and found the pleadings to not trigger a defense:

- *Markel Int’l. Ins. Co. v. Campise Homes, Inc.*, 2006 WL 1662604 (S.D. Tex. 2006)—where policy period was March 26, 2001-02 but pleading only alleged homebuilding began in 2000 and purchase contract with plaintiffs in August 2000, there was “simply too great of a gap between the date of the written purchase contract and the start of coverage”.
- *Amerisure Mut. Ins. Co. v. Travelers Lloyds Ins. Co.*, 2010 WL 1068087 (S.D. Tex. 2010)—where pleading alleged that insured completed construction on 3/17/04 and that roof deck problems were *discovered* 12/06, no duty to defend after *Don’s Building* under policy covering the period 1/21/04 through 1/1/05 *absent any allegation of an earlier date of actual injury*.

And in some cases the court has concluded, even after *Guide One*, that the limited exception to the “8 Corners” rule that *Guide One* hinted at allowed extrinsic evidence on the date of damage:

- *Boss Management Services, Inc. v. Acceptance Ins. Co.*, 2007 WL 2752700 (S.D. Tex. 2007)—where pleadings simply alleged damage occurring at some unspecified date after building construction was completed and building became occupied, certificates of occupancy could be considered to peg the date of occupancy in late 1998 so that water infiltration, mold and mildew must have occurred thereafter; and thus, applying the mere potential for coverage (Subset Rule No. 1), court found coverage triggered under policies that ran from Sept. 2000 to Sept. 2003.

PRACTICAL APPLICATION--Accordingly, under the Hypo Case, the pleadings only allege the date of the contract and the date the damage was discovered. In representing the policyholder:

- If the dates involved as to date of discovery/contract as compared to the period of the policy are such that it does not require an unreasonable leap of logic or common sense to infer that some damage may have occurred during the policy period involved, then simply rely on Subset Rule No. 1 and argue that the pleadings should be liberally construed to potentially allege some damage may have occurred within the policy period;
- If there are allegations of the discovery rule in an effort to prevent a statute of limitations defense, such allegations necessarily suggest that damage may have been present before actual discovery, and thus open the door to arguing Subset Rule No. 1 in order to push the date of actual damage occurrence back to an earlier date prior to discovery.
- If there is extrinsic evidence that fills in the dates favorably for the insured, and it would not overlap with any liability issue or contradict the pleadings, argue that extrinsic evidence of the applicable date(s) falls within the limited "coverage only facts" exception to the "8 Corners" rule suggested by *Northfield* and *Guide One* attempt to use it to show the date of damage within the period.
 - But, caution: if Statute of Limitations is at issue and plaintiff has pleaded more recent dates of damage or discovery in an effort to avoid limitations, the carrier can argue that extrinsic evidence pushing the date back to an earlier point in time does overlap liability and thus any limited exception is not applicable.

CAN THE CARRIER DENY DEFENSE UNDER THESE BROAD, NONSPECIFIC PLEADINGS BASED ON THE STANDARD CGL EXCLUSIONS THAT EXCLUDE COVERAGE FOR DAMAGE TO THE "INSURED'S WORK" (EXCLUSION L) OR "IMPAIRED PROPERTY" (EXCLUSION M)?

A. EXCLUSION L-"INSURED'S WORK" EXCLUSION (SUBCONTRACTOR WORK EXCEPTION)

This exclusion usually reads as follows:

L. Damage to Your Work

"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.

This exclusion can be summarized as follows: It excludes coverage to "property damage" to the insured's own "work" if that work is completed (as defined in the policy) at the

time the damage occurs, unless the defective work at issue was done by a subcontractor. For cases construing the exclusion and its parameters, see *Wilshire Ins. Co. v. RJT Construction, LLC*, 581 F.3d 222, 226 (5th Cir. 2009); *Travelers Ins. Co. v. Volentine*, 578 S.W.2d 501, 503 (Tex. Civ. App.—Texarkana 1979); *American Home Ass. Co. v. CAT Tech, LLC*, 2010 WL 2331395, *14-16 (S.D. Tex. 2010); *Building Specialties, Inc. v. Liberty Mutual Fire Ins. Co.*, 2010 WL 1990115, *18-21 (S.D. Tex. 2010).

In representing the policyholder and dealing with the various construction-related exclusions in the CGL policy, the best argument will frequently be simply that the exclusions, while perhaps applicable to some of the allegations or claimed damages, are not applicable to everything alleged or potentially alleged. They rarely will be. And that is all that you need to show to overcome them at least as to getting a defense since the carrier must defend the entire suit, generally, if any part of it, however small, is potentially covered.

Accordingly, it is important to first understand what the exclusions apply to and what they do not apply to. With regard to Exclusion L, commonly referred to as the “insured’s work” exclusion, it only applies to (1) completed work (2) of the insured and (3) and only if the defective work or damaged work was NOT done by a subcontractor. Thus, the exclusion will not operate to deny defense in any of the following circumstances:

- Any part of the damage alleged “occurred” (i.e. under *Don’s Building*) before the insured’s work was “completed” (as defined in the CGL policy “Definitions” section) on the project;
- If the allegedly defective work of the insured resulted in damage alleged to have occurred to anything else that is not the work of the insured;
- If defective work that caused the damage was done by a subcontractor, or the work that was damaged was done by a subcontractor.

Since this exclusion does not apply to defective work done by the insured’s sub, it will rarely apply to a general contractor or builder that uses subs to do most of the work with the builder/contractor simply acting in an oversight supervision capacity. On the other hand, where the insured is the subcontractor involved, this exclusion can be very problematic and will usually knock out coverage for a large portion of the claimed damages if the claims are mostly related simply to a need to redo the work. Even in those cases, however, if the defective work has caused resulting damage to other subs’ work or otherwise to something other than the insured’s own work, even if that is a small part of the overall damages, this exclusion will not allow the insurer to deny defense.

But what happens if, as in the hypo, the pleadings in the case are general and broad and do not specify whether subs were involved or whether the work was complete or not?

First, unfortunately for policyholders, while whether the insured did the work itself or had subcontractors doing work on its behalf would appear to be precisely the type of “coverage only” fact that extrinsic evidence ought to be allowed on, the Texas Supreme Court has instead

viewed it as touching on the liability issues and not subject to being proven beyond the allegations.

In this connection, in *Pine Oak Builders, Inc. v. Great American Lloyds Ins. Co.*, 279 S.W.3d 650 (Tex. 2009) there were multiple underlying suits involved, four of which expressly alleged that the defective work was done by the insured's subcontractor and one of which—Glass—contained no allegations of any subcontractor involvement. Pine Oak submitted evidence in the coverage case showing that a subcontractor was also involved in Glass and argued that such evidence invoked the “subcontractor exception” to Exclusion L and that Great American, thus, had a duty to defend Glass as well as the other suits. The Texas Supreme Court, however, viewed subcontractor involvement v. no subcontractor involvement as touching the merits of the liability allegations since for whatever reason (perhaps because the underlying homeowners did not care one way or the other whether Pine Oak used subs or not since Pine Oak was responsible to them for everything as the builder of the homes) the Glass plaintiff had alleged that Pine Oak did the allegedly defective work. *Pine Oak*, 279 S.W.3d at 654-55. In other words, the court viewed the issue as one controlled by Subset Rule No. 2 and would not, therefore, allow either extrinsic evidence or reading into the pleading anything not alleged.

Of course, Pine Oak did do all of the work; it was the builder of the home. Whether it did so itself through its own employees or instead by hiring various subcontractors was completely irrelevant to whether Pine Oak's construction (done by whoever) was negligent, breached warranties or breached contracts. But the issue of whether the work was actually performed by Pine Oak itself through its own employees or instead actually performed by a subcontractor on its behalf was THE coverage issue and one could just as easily characterize the underlying pleadings as calling for application of Subset Rule No. 1 or at least as falling within the “coverage only facts” extrinsic evidence exception. After all, evidence that the work involved was done by a subcontractor meets all of the requirements of the limited exception since whether a sub did the work or Pine Oak itself did it does not affect, challenge or otherwise engage the merits of Pine Oak's alleged liability; as builder it is liable to the homeowners irrespective of whether the defective work was done by Pine Oak itself or by a subcontractor of Pine Oak. Thus, the Texas Supreme Court got it wrong in holding that evidence of sub involvement somehow would contradict the merits of the liability allegations. If it did, then Pine Oak and other homebuilders can apparently escape liability for defective construction by simply asserting that any defective work was done by their subcontractor for whom they are not liable. That has never been the law in Texas and is not now even after *Pine Oak*. And, it belies common sense to suggest that a pleading against a home builder complaining of a defective home but silent on any subcontractor involvement somehow can only be reasonably construed as conclusively negating any subcontractor involvement by only mentioning the builder itself. Yet that is the Court's conclusion in *Pine Oak*.

Courts in several recent cases have now followed and applied *Pine Oak* to preclude an insured from proffering extrinsic evidence of subcontractor involvement in the defective work in an effort to show that exclusion L does not apply. *Colony Ins. Co. v. Peachtree Construction Co.*, 2009 WL 3334885, *4 (N.D. Tex. 2009); *Building Specialties, Inc. v. Liberty Mutual Fire Ins. Co.*, 2010 WL 1990115, *18-19 (S.D. Tex. 2010).

Thus, under *Pine Oak*, if the pleadings against a general contractor/builder do not contain any allegations mentioning possible involvement of subcontractors in the allegedly defective construction, then unless the allegedly defective work causes consequential damage to something other than the home, building or structure being constructed by the insured, Exclusion L will allow the insurer to deny defense as long as the work is complete as of the time the damage occurs.

Note however that not much by way of allegations may be required in order to bring the pleadings within the scope of Subset Rule No. 1 when it comes to subcontractor involvement. In *Global Sun Pools, Inc. v. Burlington Ins. Co.*, 2004 WL 878283 (Tex. App.—Dallas Aug. 23, 2004, no pet.) the court held that allegations that Global had built the swimming pool in question and “did send its builders to construct the pool and deck” was sufficient to invoke Subset Rule No. 1 for purposes of invoking additional insured coverage for Global on the policy issued to its subcontractor who had actually built the pool even though the petition did not otherwise mention the sub by name.

In the Hypo, even if it is undisputed that a subcontractor of the insured was involved in the construction of the allegedly defective roof, if the pleadings in the hypo are completely silent on any sub involvement, the policyholder attorney cannot escape the exclusion by presenting extrinsic evidence of sub involvement; such evidence is barred under *Pine Oak’s* tortured application of the “8 corners” rule. The policy holder lawyer will have to look elsewhere for relief.

PRACTICAL APPLICATION--The policyholder lawyer, in our hypo, should therefore consider the following alternatives:

- Do the pleadings clearly establish that the insured’s work was “completed” at the time the damage occurred, with focus on Subset Rule No. 1 that requires all doubts to be resolved in favor of the insured ?
 - Under the hypo assumptions, the pleading only alleged the date that the contract was entered into and the date the damage was discovered; thus does the pleading necessarily allow one to conclude either way whether the work was completed or not at the time the damage first occurred? Subset Rule No. 1 requires any reasonable doubts about that to be resolved in favor of the insured. And Subset Rule No. 2 prohibits reading in a date of completion that was before the damage occurred.
 - Conversely could the pleading be read to reasonably suggest that it is at least plausible that the date of damage was before the insured’s work was all completed? Again, all doubts are resolved in favor of the insured.
 - Policyholder counsel should carefully analyze the specific policy definition of “products—completed operation hazard” as contained in the CGL policy, as that is the definition that defines when work is complete or not. Do the allegations of the suit clearly establish that such definition of “completion” is satisfied if Subset

Rules No. 1 and 2 are applied; if not, then exclusion L may not apply, at least on duty to defend.

- Are there any allegations suggesting that the allegedly defective roof work caused any damage to something other than the insured's construction work itself? If so, then exclusion L will not allow the insurer to deny defense even if such other damage is minor compared to the bigger damage mostly at issue.
- If all else fails, then as policyholder counsel, it may be prudent to let the Plaintiff attorney know that his/her failure to reference any subcontractor involvement or damage to anything other than the insured's own work in the pleadings could result in complete lack of coverage. In *Pine Oak*, the court noted that the pleading was completely silent on any possible subcontractor involvement and thus, applying Subset Rule No. 2, the court held that it could not read those facts into the pleading or imagine that factual scenario. If the pleading had simply referred to "Pine Oak itself and/or by and through its subcontractors" or the like that probably would have been enough to change the outcome under Exclusion L.

B. EXCLUSION M-"IMPAIRED PROPERTY" EXCLUSION

This is one of the most complicated and often misunderstood exclusions the policy. Typically it reads as follows:

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

- (1) A defect, deficiency, inadequacy or dangerous condition in "your product" or in "your work"; or,
- (2) A delay or failure by you or anyone else 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.

Then the policy defines "Impaired Property" typically as follows:

"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:

1. The repair or replacement, adjustment or removal of “your product” or “your work” or
2. Your fulfilling the terms of the contract or agreement.

This exclusion was designed to preclude coverage for “loss of use” claims that stem from the insured’s failure to perform its contractual undertakings or due to some correctible defect in the insured’s work or product where there has been no damage to anything other than the insured’s own work or product. See, *American Mercury Ins. Group v. Urban*, 2001 WL 1723734 (D. Kan. 2001); *Standard Fire Ins. Co. v. Chester O’Donley & Assoc., Inc.*, 972 S.W.2d 1, 10 (Tenn. App. 1998). It does not apply, by its own terms, if the insured’s defective work cannot be repaired or replaced without causing physical injury to other property or if the loss of use of other property was caused by the “sudden and accidental” physical injury to the insured’s product or work after it has been put to its intended use. *Standard Fire*, 972 S.W.2d at 10.

As one commentator known well to regular attendees of this seminar has asserted, “there may be no less than 11 steps in the analysis of an impaired property claim.” Wielinski, *Defective Construction*, p. 197. One court said of the exclusion “Considering the difficulty this provision presents to this court in its own effort to decode Fireman’s policy, we conclude that this exclusion is unintelligible from the standpoint of a hypothetical reasonable insured . . .” *Computer Corner Inc. v. Fireman’s Fund Ins. Co.*, 46 P.3d 1264, 1270 (N.M. App. 2002). Another court simply concluded that it was “hopelessly” ambiguous. *Serigne v. Wildey*, 612 So. 2d. 155 (La. App. 1992).

Thus, not surprisingly, insurers have not had much success in relying on the exclusion. *Federated Mutual Ins. Co. v. Grapevine Excavation, Inc.*, 197 F.3d 720, 727-8 (5th Cir. 2000) *Mt. Hawley Ins. Co. v. Steve Roberts Custom Builders*, 215 F.Supp. 2d 783, 792-3 (E.D. Tex. 2002)(finding exclusion inapplicable where physical injury to property is alleged); *McKinney Builders, Inc. v. Nationwide Mut. Ins. Co.*, 1999 WL 608851, *9 (N.D. Tex. 1999) (finding exclusion ambiguous).

However, that does not mean that the exclusion is never applicable to deny defense as evidenced by *St. Paul Surplus Lines Ins. Co. v. Geo Pipe Co.*, 25 S.W.3d 900 (Tex. App.—Houston [1st Dist.] 2000, no pet.). And that case, arguably is an example of the limited circumstances under which the exclusion was intended to apply. There, the insured supplied tubing that was incorporated down into Plaintiff’s oil well. The tubing eventually corroded over time resulting in pressure problems in the well and Plaintiff had to remove and replace the tubing at significant cost and sued the insured. The court held that the exclusion applied. *Id.* at 906. The well was the “impaired property” because (1) it was not the insured’s own work or product, (2) it incorporated the insured’s defective tubing and (3) it could be completely restored by replacing or repairing the tubing. And there was no sudden or accidental failure of the tubing so as to invoke the exception to the exclusion.

PRACTICAL APPLICATION--So, returning to our Hypo, In representing the insured as to the carrier’s assertion of the “impaired property” exclusion counsel should:

- Argue that the exclusion does not apply by its own terms to everything because at a minimum the allegedly defective roof is the “insured’s work” and thus, by definition is not within the wording of the exclusion;
- Argue further that the exclusion does not apply by its terms to the extent that the pleadings either establish or leave open (i.e. under Subset Rule No. 1) that there may have been a sudden and accidental failure of the roof so as to invoke the exception to the exclusion;
- Argue that as found by at least some courts (see above) the exclusion is ambiguous, unintelligible etc.

Rarely will this exclusion, at least by itself, afford the carrier the right to deny defense in most typical construction defect claims. But a word of caution. This exclusion combined with Exclusion L (or one of the other construction related exclusions—J5, J6) can sometimes operate together to deny coverage for everything. For example, in our hypo, if the defective roof did not cause or result in any damage to anything else (i.e. there were no water leaks damaging any other work), and no subs were involved, then Exclusion L would operate to deny coverage for the defective roof itself and the Impaired Property exclusion would operate to deny coverage for any claim of loss of use of the building during the period of repair.

CAN THE CARRIER DENY DEFENSE TO “TEXAS INSURED BUILDERS, INC.” SINCE THE INSURED ON THE POLICY IS “INSURED BUILDERS, INC.”?

This issue raises the question of whether extrinsic evidence, even if otherwise generally not permitted, is permitted under a limited exception to the “8 corners” rule when the issue is the threshold question of whether the party seeking coverage is an insured in the first instance.

The standard CGL policy insuring agreement, at least historically, provided that the duty to defend suits was, “even if the allegations are groundless, false or fraudulent”. That language is the original source of the courts’ adoption of the “complaint allegation” rule in the first place. It was a matter of contract, a benefit conferred by the policy. It necessarily therefore is only a benefit that the parties to the contract are entitled to. As such, the entire “8 corners” or “complaint allegation” rule, as a matter of basic contract law and logic, is only applicable between the insurer and an insured, i.e. an actual insured, not someone claimed by some third party (i.e. the plaintiff) to be an insured. Conversely, an actual insured under the policy should not be deprived of one of the main contracted benefits provided by the policy, i.e. defense, simply because the allegations made by the plaintiff incorrectly or falsely paint the insured as not an insured. **In other words, the “complaint allegation rule” should be completely irrelevant in determining in the first instance whether the party demanding a defense is an insured or not.** If they are, then they get the benefit of the “8 Corners” rule in construing the allegations made against them v. the policy coverage; if they are not, no pleading by a third party (i.e. the plaintiff) should be allowed to confer the benefits of a contract on them that in truth they are not entitled to.

At least some courts and commentators agree with the forgoing, i.e. that the “complaint allegation” rule should not be employed in determining the threshold issue of whether the party seeking a defense is an insured under the policy in the first instance. Windt, *Insurance Claims and Disputes*, 5th Ed. Section 4:1, n. 61 (and cases cited therein). Thus, from the policyholder’s perspective, if the carrier denies defense to someone that clearly qualifies as an insured on the ground that the allegations do not allege sufficient facts to confer insured status, the policyholder should argue that the “8 corners” rule does not control the initial determination of who the insured is and that to allow missing or mistaken allegations of a complete stranger to the policy (i.e. the Plaintiff) to deprive the insured of the benefit of a defense that the insured contracted and paid for under the policy is simply wrong.

Of course, as noted, such a logic based rule cuts both ways—if the allegations allege facts qualifying someone as an insured but the true facts negate any insured status, then the non-insured does not get the benefit of the “8 corners” rule either.

One example of the type of “fundamental coverage issue” upon which extrinsic evidence would be admissible even under a limited exemption, according to the Texas cases discussed above, is “whether the person sued has been specifically excluded by name or description from coverage.” *Loving Home Care*, 363 F.3d at 530-31. Thus, there is an argument to be made that even if the extrinsic evidence exception is very limited, whether someone qualifies as an insured in the first instance is a fundamental coverage issue that can be addressed via extrinsic evidence, at least as long as such evidence does not require controverting the allegations in any way.

In somewhat analogous situations, at least historically, Texas courts have viewed the “who is an insured” question as a fundamental coverage question that can be answered with extrinsic evidence if it cannot be answered from the pleadings. For example, in *International Service Ins. Co. v. Boll*, 392 S.W.2d 158, 160-61 (Tex. Civ. App.—Houston 1965, writ ref. n.r.e.) the policy excluded, by name, the named insured’s son from coverage and the petition simply alleged that the car involved in the accident was driven by the insured’s son but did not identify him as the same son that the policy excluded. The court held that notwithstanding the “8 corners rule”, extrinsic evidence that the named insured only had one son and that he was same son excluded and involved in the accident was admissible and the insurer had no duty to defend.

In *Cook v. Ohio Cas. Ins. Co.*, 418 S.W.2d 712, 714 (Tex. Civ. App.—Texarkana 1967, no writ), similarly, the court held that the “known or ascertainable” fact that Ms. Cook was driving her mother’s car at the time of the accident and was an excluded driver on her mother’s policy was admissible and the carrier, thus, had no duty to defend her.

However, if the issue requires getting into the merits, then the answer may be different. In *D.R. Horton v. Markel Intern. Ins. Co.*, 300 S.W.3d 740 (Tex. 2009) one issue was whether D.R. Horton was entitled to be defended as an additional insured on a sub’s policy that contained an additional insured endorsement that required that the sub’s work be involved. As in *Pine Oak*, the pleading was silent as to any involvement of any subs. If the same reasoning of *Pine Oak* is applied here as was applied there to bar extrinsic evidence of sub involvement, even though the

issue here is Insured status, and not the application of the exclusion to an undisputed insured, then no extrinsic evidence would be allowed. As noted earlier, the Texas Supreme Court dodged that issue in *D.R. Horton* by concluding that D.R. Horton had waived its extrinsic evidence argument in the court below by not making it.

But even if, after *Pine Oak*, extrinsic evidence is not admissible to shed the light of truth on whether someone qualifies as an additional insured if such evidence is viewed as merits-related, that is a different scenario entirely than simply determining if one corporate entity is sufficiently related to the named insured entity so as to qualify as a named insured as in the hypo.

In fact, in *VRV Dev. v. Mid-Continent Cas. Co.*, 2010 WL 375499 (N.D. Tex. 2010), the court found that the insurer could present extrinsic evidence outside of the pleadings to show the circumstances surrounding the conversion of the corporation named in the policy into the limited partnership entity being sued so that coverage did not apply to the converted partnership entity. The court found this issue to be a fundamental coverage issue that did not touch on the merits.

PRACTICAL APPLICATION-- Thus, assuming that the hypo facts as to the relationship between Insured Builders, Inc. and Texas Insured Builders, Inc. are such that Texas Insured Builders, Inc. also qualifies as an insured under the policy, then the attorney for them should argue that extrinsic evidence showing that Texas Insured Builders, Inc. qualifies as an insured is properly admissible on that threshold issue irrespective of the fact that the allegations are missing.

CONCLUSIONS

In conclusion, therefore, in representing a policyholder in securing a defense under a standard CGL type policy, keep the following in mind:

- In all but the rarest of construction defect cases after *Lamar Homes* the petition will almost always potentially allege an “occurrence”;
- To the extent that the pleadings are silent on some key fact or date critical to being established in order to trigger coverage, carefully review what facts the pleadings do allege to see if you can make an argument for application of Subset Rule No. 1 (liberal construction of the pleadings/all doubts resolved in the insured’s favor) in which case you do not have to even get to the issue of extrinsic evidence;
- If the pleadings are not susceptible of easily falling under Subset Rule No. 1 without extrinsic evidence in addition, then marshal the extrinsic evidence to fill in the missing critical facts and rely on the cases discussed herein to argue that the extrinsic evidence does not touch the merits of liability and thus is properly considered;
- Understand what the standard construction-related exclusions (J5, J6, L and M) apply to and do not apply to according to their own wording and cases interpreting them and

then look for allegations of damages that fall outside of them, or if the pleadings contain no facts from which you can determine if they apply, invoke Subset Rule No. 1.

- If there are any allegations that the insured's defective work was done by a sub, or damaged the work of another sub, then Exclusion L is not applicable;
- If the insured's work was not yet complete at the time of the damage then exclusion L will not apply (but be careful in that case to examine whether exclusions J5 or J6 may apply);
- The Impaired Property exclusion (Exclusion M) will rarely apply by itself to allow the carrier to deny defense; argue that it has been found to be ambiguous and unintelligible as per the cases cited above.
- If all else fails and the problem is that the pleading as drafted by the Plaintiff counsel simply does not invoke coverage or falls within an exclusion, then have a chat with him/her.