

CGL COVERAGE FOR BREACH OF CONTRACT 2000 UPDATE

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I. INTRODUCTION

When construction work proves to be defective, claims against the insured contractor can involve many facets – lost profits for the owner when the defect prevents a building from opening on schedule; damage to the interior when a roof fails, or even serious property damage in a catastrophic collapse. All of these claims usually involve breach of contract. Depending on the particular claim, only breach of contract might be alleged. Some insurers deny coverage for such claims on the basis that the insured is not “legally obligated” to pay damages arising out of a breach of contract. They may also assert that the CGL policy provides coverage only for tort damages. Coverage for other claims is questioned on a theory that a breach of contract does not constitute an occurrence under a CGL policy. Since the courts of several states have upheld these controversial arguments, these types of claims have become the crest of a wave of defective work coverage litigation. Over the past year, Texas courts have had the opportunity to address some of these issues.

A. The Contractor’s Commercial General Liability Coverage and Construction Risks

Construction is a dangerous business, and as a result, significant risks are sought to be transferred among the numerous parties on any construction project. Some risk transfer devices involve a single contract or agreement between two parties, such as an indemnity agreement. The majority of risks, even those transferred pursuant to an indemnification agreement, are usually supported by insurance, thus ultimately transferring the risk to a third party, an insurer more financially capable of bearing and spreading it.

The major means to insure property exposures on a construction site is through first party property insurance, that is, builders risk coverage. On the other hand, the major source of insurance protection for third party claims for any insured business, including owners, developers and contractors, is the commercial general liability (CGL) policy. In many instances, the line between builders risk and CGL coverage blurs, in that a CGL policy may provide coverage for a contractor, particularly for defective work, coverage which either coincides with, or is excess of coverage provided under the builders risk policy. Moreover, even in the event of a recovery under the builders risk policy, the carrier may seek recovery from the responsible contractor or subcontractor in the absence of a waiver of subrogation in the contract documents or where they are not insured on the builders risk policy.

Due to the blurring between the property damage coverage under CGL policies and first party property insurance, exclusions relating to the work of contractors are included in CGL policies. This approach may work well with many types of insureds, but contractors and other service providers

face property damage liability exposures which are not easily or cost-effectively covered under standard property or inland marine policies. These exposures lend themselves to coverage under liability insurance. For the most part, these types of exposures involve fortuitous occurrences, for example, where an electrician's faulty wiring of an elevator may burn down an entire building.

Nowhere is the distinction between first property coverage and liability coverage more blurred than in the area of defective work. Since builders risk policies, to a large extent, exclude coverage for defective work, owners, developers and contractors typically look to the CGL policy for coverage for this exposure. This exposure often dovetails with the insured's so-called "business risks," that is, those risks which are apparently under the control of the insured and which are, therefore, not regarded as fortuitous in nature. Understandably, carriers are hesitant to insure these types of risks, but it is often extremely difficult to distinguish between uninsurable business risks and accidental property damage covered under a CGL policy. These claims give insurers and insureds fits and the insurance industry has struggled for decades to draft policy language to accomplish this goal.

The current CGL policy form was promulgated in 1986 and, for the most part, incorporated the scope of coverage previously provided to a contractor by virtue of an endorsement commonly referred to as the "Broad Form Property Damage Endorsement" ("BFPD endorsement") which was attached to the prior policy form, revised as of 1973. While CGL coverage for most contractors has been written on the 1986 form since that form was approved by regulators, certain long-tail or delayed injury claims may still involve policies written on the 1973, or even older, forms. Moreover, in some states, including Texas, current CGL coverage written by surplus lines or non-admitted carriers may still be on the 1973 form. Thus, a basic understanding of the relationship between the evolution of the 1973 and 1986 forms is helpful in addressing defective work claims.

Very broadly, these exclusions have been historically ineffective in eliminating coverage for defective work claims. Therefore, carriers have begun to emphasize arguments based on other provisions in the policy to defeat coverage for these claims. Those arguments include (a) whether claims involving breach of contract constitute occurrences under the policy; (b) whether the insuring agreement provides coverage for claims which involve breach of contract; and (c) whether the contractual liability exclusion applies to deny coverage. Arguments based on the applicability of the so-called "work product" exclusions becomes secondary in the event a claim does not survive a coverage defense based on one or more of these provisions.

It goes without saying that most defective work claims against contractors involve a breach of contract, largely because most contractors perform their services pursuant to written contracts with owners, developers or other contractors. While many defective work claims may be framed in terms of negligence or breach of warranty, most claims include allegations of breach of contract. In fact, in many claims brought by an aggrieved owner against a contractor, only breach of contract may be alleged. On occasion, where defective workmanship has caused damage to an ongoing project, there may be no litigation, or even demand, made by the owner upon the contractor. Rather, in light of its contractual obligation to construct the project, the contractor repairs the damage, incurring the costs of doing so itself. That contractor's insurer, however, may have difficulty finding coverage for

that claim, even if there has been an occurrence of property damage as required under the CGL policy.

II. BREACH OF CONTRACT AND THE OCCURRENCE REQUIREMENT

A CGL policy provides coverage for those sums which an insured is legally obligated to pay as damages because of “bodily injury” or “property damage” to which the insurance applies. The insurance applies to property damage caused by an “occurrence.” The definition of occurrence is of critical importance to the defective work claim. Nevertheless, the term is defined in deceptively simple language in the policy as follows:

‘Occurrence’ means an accident, including continuous or repeated exposure to substantially the same general harmful conditions.

In terms of CGL coverage for claims involving breach of contract, the elements of “accident” and “fortuity” are the key concepts.

A. Accident and Fortuity Requirement

Prior to 1966, CGL coverage was accident-based in that coverage was provided for bodily injury and property damage “caused by an accident.” However, early case law indicated the move toward occurrence-based coverage. For example, the seminal case of *Hauenstein v. St. Paul-Mercury Indemnity Co.*, 65 N.W.2d 122 (Minn. 1954), involved an insured distributor of plaster which had shrunk and cracked upon application to various buildings. The plaster had to be removed so that the walls could be replastered with a different material. The court held that there could be no doubt that the property damage to the building caused by the application of the defective plaster was caused by an accident under the insuring agreement of the policy, “since the damage was a completely unexpected and unintended result.” Accident, as a source and cause of damage to property, within the terms of an accident policy was an unexpected, unforeseen, or undesigned happening or consequence from either a known or an unknown cause.

In 1966, CGL forms were revised to provide for coverage based upon an occurrence, 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.” This definition, without substantial revision, has been maintained through the 1986 revisions at which time the definition set out above was incorporated into the policies. The “neither expected nor intended from the standpoint of the insured” requirement was moved to an exclusion, Exclusion (a) in the 1986 form.

Regardless of the particular formulation of the occurrence definition, the hallmark of the covered occurrence is fortuitous damages which are not the natural and probable consequence of intentional conduct. For example, in *Bituminous Cas. Corp. v. Vacuum Tanks, Inc.*, 75 F.3d 1048 (5th Cir. 1956), the court stated as follows:

Texas courts afford coverage for fortuitous damages but deny coverage when damages are the natural and probable consequence of intentional conduct. Regardless of whether the policies involved are worded to cover ‘accidents’ or ‘occurrences,’ all offer minor variations of the same essential concept; coverage does not exist for inevitable results which predictably and necessarily emanate from deliberate actions.

Moreover, the separation of the “unexpected or unintended from the standpoint of the insured” requirement from the definition of occurrence to a separate exclusion in the 1986 policy has not significantly affected the determination of occurrence. In *High Country Associates v. New Hampshire Ins. Co.*, 139 N.H. 39, 648 A.2d 474 (1994), the insured contractor defectively constructed a condominium project. Among other things, the insurer argued that the policy’s definition of occurrence should be limited by the interpretation of accident in the definition. *Id.* at 477. In construing the 1986 definition of occurrence, the court held that the term “accident” in the definition of “occurrence” meant circumstances, not necessarily a sudden and unidentifiable event, which were unexpected and unintended from the standpoint of the insured. The damage alleged by the condominium association was unexpected from the standpoint of the insured contractor and was caused by continuing exposure to moisture seeping through the walls of the units. The allegations of damage fit within the interpretation of accident and the definition of occurrence in the policy. Thus, even though the “unexpected and unintended” language has been separated from the definition of occurrence, these terms still define “accident” under a CGL policy.

The determination of occurrence should not be dependant upon the type of allegations made against the insured, i.e., whether those allegations are based in tort or breach of contract. For example, in determining the duty to defend, an insurer must look at the facts alleged in the petition filed against the insured, and not the legal theories. *National Union Fire Ins. Co. v. Merchants Fast Motor Lines, Inc.*, 939 S.W.2d 139 (Tex. 1997). The debate over the status of defective work as an occurrence centers around the question of whether the conduct was an intentional act versus an accidental injury or whether coverage is sought for a business risk. Robert J. Franco, “Insurance Coverage for Construction Claims,” *Construction Law* §9.11 (1997). Suffice it to say where conduct causing property damage is unintended, a court should more likely find an occurrence. Nevertheless, this determination is highly fact-intensive and often, differences in state law which may take into account subjective versus objective intent of the insured, will have a profound effect on the existence of an occurrence. While the specific causes of action alleged against the insured, that is negligence versus breach of contract, should not be conclusive as to whether there has been an occurrence or accident within the coverage of the policy, as a practical matter, an insurer is more likely to at least provide a defense in a defective work claim if the underlying lawsuit contains an allegation of negligence on the part of the insured.

B. Breach of Contract as Occurrence: Texas Law

There are two lines of cases under Texas law which can most simply be distinguished and discussed based upon the type of conduct for which the insured seeks coverage. One line of cases involves coverage for negligent or unintentional acts, and the other lines of cases involves coverage for intentional torts or acts. In essence, Texas courts find a covered occurrence where the property

damage is unexpected or unintended, and they deny coverage where the bodily injury or property damage results from intentional torts. This analysis was recently confirmed by the Fifth Circuit, applying Texas law, in *Federated Mut. Ins. Co. v. Grapevine Excavation, Inc.*, 197 F.3d 720 (5th Cir. 1999), discussed below.

1. Negligence or Unintentional Line of Cases

The seminal case in this line is *Massachusetts Bonding and Ins. Co. v. Orkin Exterminating Co.*, 416 S.W.2d 396 (Tex. 1967), a case where the insured was found negligent in the application of a pesticide to rice and premises. The policy provided coverage for property damage “caused by accident.” The insurer denied coverage, asserting that the application of the pesticide was not an “accident” within the coverage of the policy. The Texas Supreme Court rejected that argument, and construed the term “accident” as used in the policy “to include negligent acts of the insured causing damage which is undesigned and unexpected.” See also, *Union Pacific Resources Co. v. Aetna Cas. & Sur. Co.*, 894 S.W.2d 401 (Tex.App. – Fort Worth 1994, writ denied) (upholding coverage where insured did not intend or expect environmental damage caused by placing industrial waste in landfill.

Hartford Cas. Co. v. Cruse, 938 F.2d 601 (5th Cir. 1991), is one of the leading cases construing “occurrence” in the context of coverage for defective construction. In *Hartford v. Cruse*, the court applied Texas law in an action in which the insured contractor sought coverage for allegations of breach of warranty, negligence and deceptive trade practices after the contractor had performed defective foundation leveling services on a home. The defective foundation leveling caused numerous other problems, including out-of-plumb doors, surfaces such as window sills and counter tops which were abnormally out of level, separation of interior walls from the floor and cracked drywall. The court, applying Texas law, stated that an occurrence takes place where the resulting injury or damage was unexpected or unintended, regardless of whether the policyholder’s actions were intentional. It then found that whenever extensive damage occurs due to the insured’s actions, the requisite accident inheres in the scope of damages.

One of the cases relied upon by the Fifth Circuit in *Cruse* was *Travelers Ins. Co. v. Volentine*, 578 S.W.2d 501 (Tex.Civ.App. – Texarkana 1979, no writ). In that case, the insured had performed a defective valve job on a customer’s automobile and as a result of the valve job, a valve keeper failed to function, resulting in the destruction of the entire engine. The court reviewed the standard definition of occurrence, the 1973 definition discussed above, and held that, while the allegedly defective performance of the work itself may not be considered an accident, the destruction of the entire engine as a result of the malfunction of one of the repaired valves was certainly unexpected and unintended, and constituted an accident within the definition of occurrence.

Another construction case on this issue is *Lafarge v. Hartford Cas. Ins. Co.*, 61 F.3d 389 (5th Cir. 1995), in which the insured contractor sought coverage for a defective coating which had caused damage to a pipeline into which it had been installed. The court flatly rejected the insurer’s argument that the failure of the coating, the insured’s product or work, could not constitute an accident. The insurer also argued that the corrosion of the pipeline was no accident because it was contemplated. The court stated as follows:

Both of these arguments are meritless. As discussed above, the complaint sought damages not simply because the coating failed but because the failure of the coating caused damage to the pipeline. As the district court correctly found, there is an accident or occurrence when the alleged product defect has caused damage to other property. [Citations omitted.] Hartford's other argument — that no accident occurred because exposure to the soil was contemplated — is equally meritless. The very purpose of the coating was to protect the pipeline from exposure to the soil. The damage caused by the defective coating was an occurrence within the meaning of the policy.

Id. at 395. See also, *Employers Cas. Co. v. Brown-McKee, Inc.*, 430 S.W.2d 21 (Tex.Civ.App. — Tyler 1998, writ ref'd n.r.e.) (under a CGL policy, an accident is an unexpected unforeseen or undesigned happening or consequence from either a known or unknown cause); *Republic National Life Ins. Co. v. Heyward*, 536 S.W.2d 549, 557 (Tex. 1976) (“natural and probable consequences of the actions or occurrence which produced the injury” are not occurrences); *Bituminous Cas. Corp. v. Vacuum Tanks, Inc.*, 75 F.3d 1048, 1054 (5th Cir. 1996) (the focus “is not on whether the insured’s conduct or actions were intentional, but on whether the insured intended the damages or injuries which are the subject of the underlying claims”).

2. Intentional Torts or Acts Lines of Cases

In *Argonaut Southwest Ins. Co. v. Maupin*, 500 S.W.2d 633 (Tex. 1973), Maupin, the insured, removed dirt from property pursuant to an agreement it had with an individual whom Maupin mistakenly believed was the property owner. The true owner subsequently sued Maupin for trespass and his liability carrier denied coverage, claiming there was no occurrence. The court held that the trespass did not constitute an accident since Maupin did what he intended to do by entering the property and removing the dirt from it. It was the intentional nature of the tort in *Maupin* which resulted in the Texas Supreme Court’s finding of no occurrence.

This was made clear by the Supreme Court of Texas in its recent pronouncement on the issue of “occurrence” under a liability policy in *Trinity Universal Ins. Co. v. Cowan*, 945 S.W.2d 819 (Tex. 1997). That case involved homeowner’s coverage for Gage, a photo lab employee who made copies of provocative photographs and showed them to his friends. Quite understandably, Gage was sued by the subject of the photographs, and even more understandably, his parents’ homeowners’ carrier refused the tender of the defense. In discussing *Maupin*, the Texas Supreme Court stated:

Maupin involved the tort of trespass, in which the only relevant intent was that of the actor to enter the property. The actor’s subjective intent or awareness of the property’s ownership is irrelevant. See, e.g., *Brannon v. Gulf States Energy Corp.*, 562 S.W.2d 219, 224 (Tex. 1977) (noting that one who mistakenly claims superior title may be a trespasser in good faith); *McDaniel Bros. v. Wilson*, 70 S.W.2d 618, 621 (Tex.Civ.App.—Beaumont 1934, writ ref’d) (holding that ‘every unauthorized entry upon land of another is a trespass’ even if no damage is done and ‘the intent or motive prompting the trespass is immaterial’).

As in *Maupin*, we conclude that Gage’s conduct was not an ‘accident.’ He did exactly what he intended to do when he purposefully copied the photographs and showed them to his

friends. That Gage did not expect or intend Cowan to learn of his actions is of no consequence to our determination of whether his actions were an ‘accident.’

Id. at 827-29. Other opinions in this line of cases include *Thomason v. United States Fidelity & Guaranty Co.*, 248 F.2d 417 (5th Cir. 1957) (trespass involving bulldozing of a golf course); *State Farm Fire & Cas. Co. v. S.S.&G.W.*, 858 S.W.2d 374 (Tex. 1993) (intentional transmission of genital herpes by insured); *Baldwin v. Aetna Cas. & Sur. Co.*, 750 S.W.2d 919 (Tex.App.–Amarillo 1988, writ denied) (intentional overloading of trucks in violation of legal weight limits of highways).

C. Collision of the Unintentional and Intentional Act Lines of Cases: Breach of Contract

The business of construction is performed through means of contracts and most property damage which occurs while work is in progress, or after it is completed, may involve a breach of contract. Therefore, claims involving allegations, or even actual, breaches of contract are unavoidable for the contractor, subcontractor or other player in the construction industry. In the eyes of most construction insureds, such a breach of contract, as long as an occurrence of property damage is involved, should not destroy CGL coverage. Nevertheless, the distinction between uninsurable intentional acts and unintentional, but insurable, damages is critical for an insured contractor’s coverage and the distinction between the two holds true pursuant to the terms of its CGL policies.

This distinction between a covered occurrence of unintended property damage and an intentional act, was blurred, due to allegations of breach of contract against a contractor, in *Federated Mut. Ins. Co. v. Grapevine Excavation, Inc.*, 197 F.3d 720 (5th Cir. 1999), a case in which the Fifth Circuit clarified many of these issues.. That case involved a Wal-Mart project in which Wal-Mart withheld \$131,000 from the contract balance due to T&S, the general contractor, in order to correct defective work allegedly performed by Grapevine, the insured excavation subcontractor. Specifically, Wal-Mart complained that the select fill installed by Grapevine failed to meet specifications for the project and damaged the crushed stone subbase and asphaltic concrete installed by another subcontractor. T&S filed suit against Grapevine to recover the amount withheld by Wal-Mart from its contract, plus attorneys fees, asserting causes of action for indemnity, negligence, breach of contract, DTPA violations and knowing DTPA violations. Maryland, the carrier, refused to defend Grapevine in the underlying lawsuit.

The trial court upheld Maryland’s denial of coverage, finding that the allegations against Grapevine set out an alleged breach of contract which produced damages which could not be characterized as unexpected or unintended in light of Grapevine’s alleged failure to meet contract specifications. Thus, there was no occurrence. *See, Federated Mut. Ins. Co. v. Grapevine Excavation, Inc.*, 18 F.Supp.2d 636 (N.D. Tex. 1998), *rev’d*, 197 F.3d 720 (5th Cir. 1999). In doing so, the court placed heavy reliance upon *Hartford Cas. Co. v. Cruse*, 938 F.2d 601 (5th Cir. 1991), a case from the “unintentional act” line of cases and which appears to have reached the opposite result. In that case, a contractor performed defective foundation leveling services which resulted in damage to other parts of the house, including out-of-plumb doors, out of level services, separation of walls from the floor and cracked drywall. The causes of action alleged against that contractor

included breach of warranty, negligence and DTPA violations. Nevertheless, since the Fifth Circuit found the damage to the rest of the house to be unexpected and unintended, it held that the defective workmanship constituted an occurrence.

The trial court stated that it was “particularly persuaded” by the following language from *Hartford Cas. Co. v. Cruse*, 938 F.2d 601 (5th Cir. 1991):

Considered in tandem with the business risk exclusion, the ‘occurrence’ requirement illuminates the allocation of risk. Direct (as opposed to consequential) damages that naturally flow from a breach of contract are conclusively presumed to have been in the contemplation of the parties and may therefore constitute expected or intended damages. A comprehensive general liability policy does not cover this cost of doing business. *A builder who fails to abide by the specifications of a contract, for example by substituting a weaker building material, may by that breach produce expected property damage to his or her work, and may thus fail to show a covered ‘occurrence.’* [Emphasis in Court’s opinion.]

Cruse at 604-605, as quoted in *Federated v. Grapevine*, 18 F.Supp.2d, at 647.

What the district court apparently did not appreciate is that a “failure to abide by the specifications of a contract” does not necessarily amount to an intentional act. The type of “failure” or negligence upon which the causes of action for breach of contract, indemnity and negligence against Grapevine were based was unintentional.

In reversing the district court, the Fifth Circuit proved capable of appreciating the possibility that property damage arising from the insured contractor’s breach of contract could be unintended and unexpected. It stated as follows:

Although GEI [the insured excavation subcontractor] readily admits that it intentionally performed under the subcontract, it denies that it intentionally submitted inferior materials – and nothing in the facts alleged by T&S supports a claim of knowing or intentional substitution of inferior fill matter. Indeed, the only allegation of knowing conduct anywhere in T&S’s complaint appears within the context of its DTPA claim.

It is well settled that an insurer’s duty to defend is triggered if at least one of several claims in the plaintiff’s complaint potentially falls within the scope of coverage, even if other claims do not. [Citing *Rhodes v. Chicago Ins. Co.*, 719 F.2d 116, 120 (5th Cir. 1983).] T&S’s fourth amended petition alleges that GEI acted negligently – that is, ‘caused damage which is undesigned and unexpected’ [footnote omitted] – which, if proved to be true, constitutes an ‘accident’ within the definition ascribed to that term by the Texas Supreme Court. In Paragraph 5 of the Petition, T&S summarizes the fact the damage to the parking lot caused by the alleged negligence of GEI as follows: ‘. . . by virtue of failing to install the correct select fill, [GEI] negligently damaged the work of [T&S’s] paving contractor [Moore].’ Therefore an ‘occurrence’ is alleged within the four corners of T&S’s complaint, and that triggers coverage. As T&S’s petition thus includes a claim that has a potential to lead to a covered loss, Maryland has the duty to defend GEI – absent an applicable policy exclusion.

Id. 197 F.3d at 726.

In *Federated v. Grapevine*, Maryland, the insurer, argued that the “scorch the earth” allegations of knowing violation of the DTPA made against Grapevine in the underlying lawsuit dictated that the intentional act line of cases be applied, particularly *Baldwin v. Aetna*, 750 S.W.2d 919 (Tex.App. – Amarillo 1988, writ denied). In that case, the allegations made against the insured was that it knowingly placed overweight trucks on Texas highways in violation of the statute. It was further alleged that the insured deliberately overloaded the trucks and that he engaged in repeated criminal law violations and created a nuisance *per se* and a public nuisance. In light of those allegations, the court in *Baldwin* held that the insurer owed no duty to defend. Therefore *Baldwin* involved no allegations of negligence or unexpected or unintended property damage, as did the petition in *Federated v. Grapevine*. Where the plaintiff’s complaint alleges multiple claims or claims in the alternative, some of which are covered under the policy and some of which are not, the duty to defend exists if at least one of the claims in the complaint is facially within the policy’s coverage. *Lafarge Corp. v. Hartford Cas. Ins. Co.*, 61 F.3d 389, 393 (5th Cir. 1995); *Rhodes v. Chicago Ins. Co.*, 719 F.2d 116, 119 (5th Cir. 1983); *Maryland Cas. Co. v. Moritz*, 138 S.W.2d 1095, 1097 (Tex. 1940). Moreover, the Fifth Circuit has specifically found a covered occurrence as to an insured contractor for property damage due to defective workmanship despite allegations of violation of the DTPA. See, *Federated v. Grapevine, supra*; *Hartford Cas. Co. v. Cruse, supra*.

The Fifth Circuit, in *Federated v. Grapevine*, set out something of a “bright line” test for determining when property damage caused by defective workmanship constitutes an occurrence under a CGL policy. There, the court stated that where the defective work in turn causes damage to the work product of a third party, as opposed to the defective work itself, that damage is presumed to have been unexpected and therefore, an accident or occurrence. In contrast, where the property damage is caused by the insured’s intentional tort, such as trespass, that damage is the natural result of voluntary and intentional acts and is deemed to not have been caused by an occurrence, no matter how unexpected, unforeseen and unintended that damage may be. This bright line test is representative of the more traditional approach by courts to this issue.

The *Federated v. Grapevine* rationale has been followed by other courts applying Texas law. In *E&R Rubalcava Constr., Inc. v. The Burlington Ins. Co.*, 2000 WL 680401 (N.D. Tex. May 25, 2000), a subcontractor was sued by the general contractor for faulty installation of a foundation. It was alleged that the faulty workmanship caused cracks in the walls and ceilings, prevented doors from shutting and windows from operating properly, caused wood frame stress and cracking and similar damage due to the weak slabs. Since the insured’s foundation work caused damage to other parts of the home, the court applied *Federated v. Grapevine*, holding that even though the plaintiff denominated its claims against the insured in terms of breach of contract, those allegations sounded in negligence, causing damage to other parts of the home. Therefore, the court found an occurrence requiring the insurer to defend its insured. Again, *Rubalcava* represents the traditional approach to the determination of these issues.

D. The Traditional versus Breach of Contract Approach

As set out above, Texas, as most recently reaffirmed in cases such as *Federated v. Grapevine* and *E&R Rubalcava v. Burlington*, follows a traditional approach as to the occurrence issue in construction defect cases. Nevertheless, it is obvious that courts continue to grapple with the issue of whether defective construction by an insured contractor constitutes an “occurrence” as defined in the standard commercial general liability policy. Despite standardized policy language, courts around the United States have, at best, produced a mixed bag of results in applying that definition to faulty workmanship. While mixed bags often defy categorization, a general trend is discernable in this occurrence case law. Those courts which utilize a strict “breach of contract” analysis tend to find no occurrence, and in turn, no coverage for the insured contractor. In contrast, those courts which employ a more traditional analysis, that is, whether the property damage was neither expected nor intended from the standpoint of the insured, tend to find a covered occurrence. Part and parcel of this analysis is a determination of whether the claim involves damage to property other than the insured’s own work. If it does, the court is more likely to find an occurrence and uphold coverage for that damage. The distinction between work and nonwork is usually lost upon most courts which employ the strict breach of contract analysis.

1. “Breach of Contract” Cases

A recent example of the “breach of contract” analysis is found in *Oak Crest Construction Co. v. Austin Mutual Ins. Co.*, 329 Or. 620, 998 P.2d 1254 (2000). There, a contractor made claim for the cost to strip and refinish painting performed by a subcontractor. The court held that there was no accident since the claim arose solely from a breach of contract and allegations that the contractor spent money to repair a subcontractor’s “deficient” painting of wood work could not support the conclusion that it resulted from the subcontractor’s breach of the duty to act with due care. This case raises several issues. First, it apparently involved only the repair of the defective work itself, that is, the insured’s subcontractor’s painting. Nevertheless, the insured contractor neither expected nor intended that the subcontractor would perform its work defectively. In addition, the court never considered whether the same conduct giving rise to the breach of contract could also be negligent, that is, whether the subcontractor’s painting was negligently performed.

A similar case implying a breach of contract approach to deny coverage is *West American Ins. Co. v. Keno & Sons Construction, Inc.*, 2000 U.S. Dist. LEXIS 2181 (N.D. Ill. Feb. 24, 2000). In that case, a water main ruptured during the construction of a water reservoir by the insured contractor, Keno. The owner filed a claim against Keno for breach of contract, alleging that Keno’s subcontractors failed to perform properly, causing the water main to rupture. The underlying lawsuit was for breach of contract, including a standard allegation that the resulting damages were foreseeable. The court rejected the contractor’s argument that the water main rupture was not intentional or expected, but instead was the result of negligence. Instead, the court held that where a claim alleges damages which are the natural result of negligent and unworkmanlike construction, there is no occurrence under a CGL policy.

2. “Traditional Approach” Cases

On the other hand, other courts have found a covered occurrence under similar circumstances. For example, in *Twin City Fire Insurance Co. v. Triple S Dynamics, Inc.*, Mealey’s Emerging Insurance Disputes, April 5, 2000 (W.D. Wash. March 1, 2000), the insured manufactured and sold two grain cleaners, both of which suffered from numerous operational problems and which eventually failed. As a result, the owner lost the use of its facility and suffered significant business interruption losses. The insurer denied coverage for the business interruption on the basis that the failure should have been expected. The court simply held that the uncontroverted evidence indicated the failure of the cleaners was unrelated to any prior problems, and, at worst, was the result of negligence. It was thus accidental under Oregon law. The court also determined that the business interruption damages stemming from loss of use of the entire plant constituted damage to other than the insured’s own product.

Similarly, in *Radenbaugh v. Farm Bureau General Ins. Co. of Michigan*, 240 Mich.App. 134, 610 N.W.2d 272 (2000), the insured was sued in an action alleging defective workmanship, breach of contract and breach of warranty after providing erroneous schematics and instructions to the excavation contractor hired by the owner for the construction of the foundation for a double-wide manufactured home. The insurer contended that since the complaint alleged breach of contract, defective workmanship and breach of warranty, there was no occurrence. The court did not agree, finding that it was clear that the underlying complaint alleged damages broader than mere diminution in value of the insured’s product – the double-wide – but rather numerous items of damage caused by the defective installation of the basement.

The long and the short of these cases is that even though courts may speak in terms of breach of contract or foreseeability, the classic test for existence of an occurrence involving defective work under a CGL policy remains whether the property damage is unexpected and unintended and whether it extends beyond the work or product of the insured.¹

III. CGL INSURING AGREEMENT AND THE “LEGALLY OBLIGATED” REQUIREMENT

A breach of contract analysis often impacts the scope of coverage available under the insuring agreement of the CGL policy. Many carriers argue that a CGL policy provides coverage only for tort liability, and not liability arising out of breach of contract under that agreement. The insuring agreement of the CGL policy provides as follows:

¹ See *Bundy Tubing Co. v. Royal Indemnity Co.*, 298 F.2d 151 (6th Cir. 1962); *City of Carter Lake v. Aetna Casualty & Surety Co.*, 604 F.2d 1052 (8th Cir. 1979); *Travelers Ins. Co. v. Volentine*, 578 S.W.2d 501 (Tex.Civ.App. – Texarkana 1979).

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. [Emphasis added.]

As a corollary, very few would quarrel with the proposition that a CGL policy’s primary purpose is to provide for a defense against, and indemnity for, third party tort claims against the insured. Nevertheless, carriers are increasingly taking the position that the “legally obligated” requirement restricts coverage solely to damages arising out of tort liability, to the exclusion of breach of contract liability. Again, this type of argument is of particular concern to contractors since the claims against them typically involve allegations of breach of contract.

A. Historical Development: California Case Law as to Coverage for Breach of Contract

The “no coverage for breach of contract damages rule” is generally regarded as having originated in California law and dates back to *Ritchie v. Anchor Cas. Co.*, 135 Cal.App.2d 245, 286 P.2d 1000 (1955). In that case, the court construed two separate coverage parts in a liability policy, each part covering different liabilities and each having its own insuring agreement. One coverage part applied to liability imposed by law, and another to liability imposed by written contract. Both types of liability were covered under insuring agreement A, but insuring agreement B applied only to liability imposed by law and was triggered by the facts in the *Ritchie* case. Based on the separate insuring agreements, the *Ritchie* policy as a whole made a distinction between liability imposed by law and liability imposed by contract so that the court’s distinction between the two types of liability made perfect sense. However, the *Ritchie* case and its reasoning does not easily transfer to present day general liability policies which usually have only a single insuring agreement and which do not distinguish between liability imposed by law and liability imposed by contract.

International Surplus Lines Ins. Co. v. Devonshire Coverage Corp., 93 Cal.App.3d 601, 155 Cal.Rptr. 870 (Cal.App. 2d Dist. 1979), misapplied *Ritchie, supra*. There, the insured sought coverage for its failure to obtain reinsurance under an insurance agency contract. The court commented on the “tort versus contractual liability” distinction, in *Ritchie v. Anchor Cas. Co., supra*, and concluded as follows:

The phrase ‘legally obligated to pay as damages’ as used in [the liability] policy, is synonymous with ‘damages for liability imposed by law.’ That latter phrase has been uniformly interpreted as referring to a liability arising *ex delicto* as distinguished from *ex contractu*. (*Ritchie v. Anchor Cas. Co., supra*). The theory that Devonshire [the agent] assumed the liability of [its principal] for which [its liability carrier] provided coverage cannot be sustained by the terms of the policy or applicable law.

Id. at 610.

What the *International Surplus Lines* court failed to perceive was that its reliance on *Ritchie v. Anchor Casualty* was misplaced. As stated above, the *Ritchie* policy, read as a whole, made a

distinction between liability imposed by law and liability imposed by contract based upon two separate insuring agreements so that its distinction between the two types of liability made perfect sense. However, that reasoning does not necessarily carry over to modern day insurance policies, the insuring agreements of which do not distinguish between liability imposed by law and liability imposed by contract.

Nevertheless, the *International Surplus Lines* court's analysis of this issue indicates that an exception to its rule exists. In considering the "no coverage for breach of contract damages" rule, the court found that the rule applied to deny coverage since there was no allegation of property damage or personal injury involved in the claim before it, but only economic damages. The court made it clear that coverage was denied because the damages sought did not arise out of covered property damage as follows: "In short, no conduct by Devonshire or Central [its principal], whose liability was assumed by Devonshire, resulted in any property damage or personal injury as envisioned by the Hartford coverage." *Id.*, 93 Cal.App.3d at 611. Had there been property damage, the *International Surplus Lines* court may have found coverage.

A similar case is *Insurance Company of the West v. Haralambos Beverage Co.*, 195 Cal.App.3d 1308, 241 Cal.Rptr. 427 (1987). In that case, an insured fraudulently refused to pay for or to return two trailers and was subsequently sued by the manufacturer in a breach of contract action for economic damages. Focusing on the type of damages sought against the insured, the court stated:

HBC [the insured] was entitled to a defense only if the Mickey Body [the plaintiff] suit potentially sought recovery for damages because of property damage or bodily injury. An analysis of the nature of damages sought in the Mickey Body action is a question of law. (*Fireman's Fund, supra*, 170 Cal.App.3d at P.995, 216 Cal.Rptr. 796.) Review of the Mickey Body complaint reveals no claim which can reasonably be construed as potentially seeking recovery for property damage and bodily injury. Quite to the contrary, HBC's liability under each of the four causes of action depended upon the existence of a contractual duty to pay Mickey Body for the two beverage trailers . . . not only was the Mickey Body action premised on a breach of contract theory, *the record contains no indication of any other facts giving rise to a claim of property damage or bodily injury.* [Emphasis added.]

Id., 195 Cal.App.3d at 1317. The presence of an occurrence of bodily injury or property damage may have altered the court's opinion.

Even within this line of California cases, the flaw in the *International Surplus Lines* reasoning has been pointed out. For example, in *Fragomeno v. Insurance Company of the West*, 207 Cal.App.3d 822, 255 Cal.Rptr. 111 (1989), a case in which the court applied the "no damages for breach of contract rule" to a dispute involving an unlawful detainer action for breach of a lease, the dissent stated as follows:

[T]he majority . . . choose[s] to follow cases holding the policy language is properly construed to cover only tort, as opposed to contract liability. (See *Fireman's Fund Ins. Co. v. City of Turlock*, (1985) 170 Cal.App.3d 988, 997-998 [216 Cal.Rptr. 796]; *International*

Surplus Lines Ins. Co. v. Devonshire Coverage Corp. (1989) 93 Cal.App.3d 601, 611 [155 Cal.Rptr. 870]. . . .

In both *Fireman's Fund* and *International Surplus*, the Courts of Appeal concluded the phrase 'shall become legally obligated to pay as damages' is the functional equivalent to 'damages for liability imposed by law' which in turn, refers to damages which are 'ex delicto' rather than 'ex contractu.' (*Ibid.*) The courts therefore conclude contract damages are excluded under this language.

Such a hypertechnical construction violates the most elementary rule of construction for policy language. 'The policy should be read as a layman would read it and not as it might be analyzed by an attorney or an insurance expert.' [Citations omitted.] At the very least this language is ambiguous, thereby necessitating courts to construe it against the insurer. [Emphasis added.]

Another California case recognizing the existence of an exception to the rule where there has been an occurrence of bodily injury or property damage is *Gulf Ins. Co. v. The L.A. Effects Group, Inc.*, 827 F.2d 574 (9th Cir. 1987), in which the court undertook a review of insurance coverage for the insured's failure to perform its contract in connection with creation of visual special effects. The court observed that the general rule is that an uncompleted contractual obligation by an insured party does not usually constitute covered property damage. Nevertheless, the court stated that inadequate performance of an insured's contractual obligation may be covered if there is a finding of property damage. In reaching that conclusion, the court relied upon *St. Paul Fire & Marine v. Sears, Roebuck & Co.*, 603 F.2d 780 (9th Cir. 1979), a construction case in which the insured had installed defective urethane which damaged a roof and which had to be replaced due to the insured's defective performance. *Gulf Ins.*, *supra*, 827 F.2d at 577.

Another recent case is *Truck Ins. Exchange v. Peck/Jones Constr. Corp.*, 62 Cal.App.4th 789, 72 Cal.Rptr.2d 851 (2nd Dist. 1998), where the insured contractor sued its CGL carrier for breach of contract after the insurer denied coverage for liability imposed on the contractor for negligently failing to meet a contractual deadline for completion. The court denied coverage, holding that even where negligent conduct gives rise to the breach of contract, the CGL policy does not cover liability based upon an alleged failure to perform a contract. Of course, this case does not fall within the general exception to the "no coverage for breach of contract" rule in that the claim against the insured involved only economic damages and not property damage resulting from an occurrence.

B. The New California Frontier: *Vandenberg v. Centennial Ins. Co.*

The most recent California case to directly address this issue is *Vandenberg v. Centennial Ins. Co.*, 21 Cal.4th 815, 982 P.2d 229, 88 Cal.Rptr.2d 366 (1999), which debunks the validity of the "no coverage for breach of contract" rationale. In that case, Vandenberg, the insured, leased real property and upon foreclosure on the lease, the owner filed suit against the insured for contamination of the property through leaking underground storage tanks. The cause of action alleged against the insured was for breach of the lease contract. At the intermediate appellate level, *Vandenberg v.*

Centennial Ins. Co., 629 Cal.Rptr.2d 511 (Cal.App. 1997), the court of appeals refused to woodenly apply the “no coverage for breach of contract” rule. In that connection, the court stated as follows:

In her action, Boyd sought damages against Vandenberg for the contamination of her property. The contamination of her property was unquestionably injury to tangible property [citations omitted]. Whether sums that Vandenberg may be required to pay to Boyd [the lessor] as a result of the contamination of her property are covered by particular insurance policies is not a matter that can be resolved by reference to the general rule that breach of contract is not covered under a general liability insurance policy. We do not suggest that Boyd’s claims are necessarily covered; rather, we conclude only that the determination must be made individually by specific consideration of the nature of the property, the injury, and the risk that caused the injury, in light of the particular provisions of each applicable insurance policy. In other words, the simple assertion that Boyd sought contract rather than tort damages does not support the claim that Vandenberg’s liability for physical injury to Boyd’s property is *per se* beyond the coverage of Vandenberg’s liability insurance policies.

Id. at 521.

The Supreme Court of California granted review of the *Vandenberg* case, *Vandenberg v. Superior Court*, 73 Cal.Rptr.2d 195, 953 P.2d 158 (Cal. 1998). One of the specific issues for which review was granted was: “Whether a general liability insurance policy may never provide an insured defendant with coverage for losses that are plead by the plaintiff as breaches of contract” *Id.*, 953 P.2d at 158.

In its *Vandenberg* opinion, the California Supreme Court resoundingly rejected the false dichotomy between “noncovered breach of contract” damages and “tort covered tort liability.” In what amounts to a quite perfunctory discussion, the court specifically disapproved the California court of appeals line of cases which had previously denied coverage for claims involving breach of contract, including *International Surplus Lines v. Devonshire*, *supra*; *Old Republic Ins. Co. v. Superior Court*, 66 Cal.App.4th 128, 77 Cal.Rptr.2d 642 (1998); *Wilmington Liquid Bulk Terminals, Inc. v. Somerset Marine, Inc.*, 53 Cal.App.4th 186, 61 Cal.Rptr.2d 727 (1997); *Bernstein v. Consolidated American Ins. Co.*, 37 Cal.App.4th 763, 43 Cal.Rptr.2d 817 (1995); *Fragomeno v. Insurance Co. of the West*, 207 Cal.App.3d 822, 255 Cal.Rptr. 111 (1989); *Insurance Co. of the West v. Haralambos Beverage*, *supra*; *Fireman’s Fund Ins. Co. v. City of Turlock*, 170 Cal.App.3d 988, 216 Cal.Rptr. 796 (1985).

In the course of rejecting this line of cases, the court described, and rejected, their reasoning as follows:

The underlying reasoning of these cases is that the phrase ‘legally obligated to pay as damages’ describes liability based upon a breach of a duty imposed by law, i.e., tort, rather than by contract. (See *Williamton*, *supra*, 53 Cal.App.4th 186, 193, 61 Cal.Rptr.2d 727.)

We disagree. The nature of the damage and the risk involved, in light of particular policy provisions, control coverage. Moreover, we reject the *ex contractu/ex delicto* distinction,

which derives from a misreading of the seminal case, *Ritchie v. Anchor Cas. Co.* (1955), 135 Cal.App.2d 245, 286 P.2d 1000 (Ritchie). In *Ritchie*, the court analyzed whether the term ‘liability imposed by law,’ the precursor to ‘legally obligated to pay,’ included coverage for liability arising from contract. (*Id.*, at p. 254, 286 P.2d 1000.) This phrase had usually been construed to mean liability imposed in a definite sum by a final judgment against the assured. (*Ibid.*). But the policy before the *Ritchie* court contained a distinction; coverage A applied to ‘“liability imposed . . . by law or by written contract,”’ whereas coverage B applied to ‘“liability imposed . . . by law.”’ (*Ibid.*). The court concluded that the omission of the term ‘“or by written contract”’ in coverage B, the portion at issue in *Ritchie*, ‘is persuasive that the phrase “imposed upon him by law” as used in this policy . . . relates to the nature of the liability to be defended rather than the result of the lawsuit. . . .’ (*Ibid.*, italics added.)

In *International Surplus, supra*, 93 Cal.App.3d 601, at page 611, 155 Cal.Rptr. 870, the phrase at issue as ‘“legally obligated to pay as damages,”’ which the court found synonymous with ‘“damages for a liability imposed by law,”’ the coverage language in the *Ritchie* case. Without further discussion, the court then held that the ‘latter phrase has been uniformly interpreted as referring to a liability arising ex delicto as distinguished from ex contractu.’ (*Ibid.*, citing *Ritchie, supra*, 135 Cal.App.2d 245, 286 P.2d 1000, italics added.) This brief statement led to a string of cases relying upon *International Surplus* for the purported distinction that ignores otherwise settled principles of insurance contract interpretation.

Id., 21 Cal.4th at 838-839.

In addition to exposing the misapplication of the *Ritchie v. Anchor Cas.* rationale by the “no coverage for breach of contract” line of cases, the California Supreme Court went on to hold that the provisions of an insurance policy should be give the meaning a lay person would ascribe to that language if that meaning is not ambiguous, citing *AIU Ins. Co. v. Superior Court*, 51 Cal.3d 807, 822, 274 Cal.Rptr. 820 (1990). The court stated as follows:

Nothing in the respective policies between Vandenberg and any of the insurers suggests any special or legalistic meaning to the phrase ‘legally obligated to pay as damages.’ A reasonable lay person would certainly understand ‘legally obligated to pay’ to refer to any obligation which is binding and enforceable under the law, whether pursuant to contract or tort liability. Further, a reasonable lay person, cognizant that he or she is purchasing a ‘general liability’ insurance policy, would not conclude that such coverage term only refers to liability pled in tort, and thus entirely excludes liability pled on a theory of breach of contract. Under general insurance principles, we must interpret the phrase ‘legally obligated to pay as damages’ in accordance with the ordinary and popular sense, not the legalistic, and erroneously premised, interpretation of the language urged by insurers.

Id. at 840.

Finally, the court observed that the arbitrariness of the distinction between contract and tort in the *International Surplus Lines* line of cases is evident when one considers that the same act may constitute both a breach of contract and a tort.

C. Case Law “From the Fringe”

Prior to the California Supreme Court’s decision in *Vandenberg*, numerous cases outside of California have followed the “no coverage for breach of contract” line of cases. While the cases ascribing to the California “no coverage for breach of contract” rationale should be seriously undermined by the *Vandenberg* decision, a review of those cases is nevertheless instructive in the event they retain precedential value even after *Vandenberg*.

Such a case is *Olympic, Inc. v. Providence Washington Ins. Co. of Alaska*, 648 P.2d 1008 (Alaska 1982), where the insured tenant sought coverage for damages arising out of its failure to procure fire insurance after a fireman was killed on the premises. The court applied the rule that “legally obligated to pay as damages” generally does not refer to breach of contract. Nevertheless, it went on to state: “[A]n exception to this general rule may arise where the contract breach itself results in injury to persons or property. In this case, the tenant’s failure to insure Olympic [the landlord] bears no causal relation to the firefighter’s death.” *Id.* at 1012.

It should be apparent that the vast majority of the “no coverage for breach of contract” cases simply do not involve actual property damage caused by an occurrence. A cursory review of the damages sought in these cases indicates that for the most part, they are on the “fringe” of coverage due to the types of damages and claims for which coverage is sought. For example, in *Aetna Cas. & Sur. v. Spancrete of Ill., Inc.*, 726 F.Supp. 204 (N.D.Ill. 1989), the insured subcontractor sought coverage for a lawsuit filed against it for breach of contract for failure to name the general contractor as an additional insured in its policy. Quite understandably, the court denied coverage, due to the fact that the insured sought coverage only for economic damages and the absence of bodily injury or property damage. The same is true of *Chamberlain v. Allstate Ins. Co.*, 931 F.2d 1361 (9th Cir. 1991), involving a dispute over the division of community property under a marital agreement, as well as *Action Ads, Inc. v. Great Am. Ins. Co.*, 685 P.2d 42 (Wyo. 1984), an action for breach of an employment contract to provide medical insurance. In all of these cases, the insured sought coverage for purely economic damages, damages which are clearly outside the scope of CGL coverage. In those cases, the courts applied the “tort versus contractual liability” distinction.

Much the same can be said as to numerous other cases which are relied upon by those commentators which espouse the theory that a CGL policy provides no coverage for breach of contract. These cases further establish that this rule is suited to claims outside the traditional parameters of “occurrence” and “property damage” as are involved in many defective work claims. Such cases include: *Action Ads, Inc. v. Great American Ins. Co.*, 685 P.2d 42 (Wyo. 1984) (economic damages for failing to purchase medical insurance); *Aetna Casualty & Surety Co. v. Spancrete of Illinois, Inc.*, 726 F.Supp. 204 (N.D.Ill. 1989) (economic damages for failure to name another party as additional insured on insurance policies); *Indiana Ins. Co. v. Hydra Corp.*, 245 Ill.App.3d 926, 615 N.E.2d 70 (1993) (breach of contract arising out of defective workmanship);

court specifically holds that damages do not constitute an accident for purposes of the definition of “occurrence” in the policy); *Fragomeno v. Insurance Company of the West*, 207 Cal.App.3d 822, 255 Cal.Rptr. 111 (1989) (unlawful detainer action for breach of lease); *Fireman’s Fund Ins. Co. v. City of Turlock*, 170 Cal.App.3d 988, 216 Cal.Rptr. 796 (1985) (economic damages for breach of city’s agreement to keep the terms of police officer’s resignation a secret); *Sylva & Hill Construction Co., Inc. v. Employers Mutual Liability Ins. Co.*, 19 Cal.App.3d 914, 97 Cal.Rptr. 498 (1971) (liquidated damages for delays in completing highway project); *Insurance Company of the West v. Haralambos Beverage Co.*, 195 Cal.App.3d 1308, 241 Cal.Rptr. 427 (1987) (economic damages for failure to pay for two trailers); *The Home Indemnity Co. v. Avol*, 706 F.Supp. 728 (C.D.Cal. 1989) (attorneys fees under lease for failure to supply habitable premises to tenants); *California Mutual Ins. Co. v. Robertson*, 213 Cal.App.3d 1172, 262 Cal.Rptr. 173 (1989) (ordered not published on Nov. 30, 1989) (economic damages arising out of action by vendor to foreclose against deeds of trust held by insureds); *Continental Ins. Co. v. Bussel*, 498 P.2d 706 (Alaska 1972) (economic damages for failure to procure life insurance); *Boiler Brick and Refractory Co. v. Maryland Casualty Co.*, 210 Va. 50, 168 S.E.2d 100 (1969) (cost of replacement boiler which could have been repaired except as required under contract); *Cincinnati Ins. Co. v. Metropolitan Properties, Inc.*, 806 F.2d 1541 (11th Cir. 1986) (damages for breach of development contract and misrepresentation); *International Surplus Lines Ins. Co. v. Devonshire Coverage Corp.*, 93 Cal.App.3d 601, 155 Cal.Rptr. 870 (1979) (economic damages for failing to obtain reinsurance); *Stanford Ranch, Inc. v. Maryland Casualty Company*, 89 F.3d 618 (9th Cir. 1996) (economic damages sought by subdevelopers asserting claims of breach of contract, misrepresentation and nondisclosure against insured master developer); *Bacon v. American Ins. Co.*, 330 A.2d 389 (N.D.Super. 1974), *aff’d*, 351 A.2d 771 (N.J. 1976) (offset recoupment pursuant to UCC §2-717).

Most of these cases simply stand for the proposition that economic damages resulting from a breach of contract are not covered under a CGL policy. However, the reason for this lack of coverage is not so much that the insured is not “legally obligated” to pay those economic damages, but rather that they do not constitute “property damage” caused by an “occurrence” within the coverage grant of the policy. Certainly, there are instances where a defective work claim is not within the coverage grant of the CGL policy. But this is not because of the vague principle that the CGL policy never provides coverage for breach of contract, an interpretation which is not supported by the policy language, but more so because the claim may not involve property damage or an occurrence. Thus, the focus in analyzing these claims must be the facts of the particular claim measured against these definitions, and not a vague notion of noncoverage for contractual damages. In the words of the California Supreme Court in *Vandenberg*, the “nature of the damage and the risk involved, in light of the particular policy provisions” must control coverage.

D. Legal and Insurance Industry Commentaries

Various legal commentators have expressed the view that the phrase “legally obligated to pay as damages” provides coverage only for tort liability. Specifically, Allan D. Windt, 2 *Insurance Claims & Disputes*, p. 244 (3rd ed. 1995), Barry R. Ostrager and Thomas R. Newman, *Handbook on Insurance Coverage Disputes*, §7.01 (8th ed. 1995), and Roland H. Long, *The Law of Liability*

Insurance, §1.01[1], p. 1-3 (1992), and frequently cited for that proposition. In that connection Windt states:

Numerous courts have held that the provision in an insuring clause agreeing to pay on behalf of the insured sums that the insured becomes 'legally obligated to pay as damages' refers to liability imposed by law for torts, and not for damages for breach of contract.

In turn, Ostrager and Newman state as follows:

The phrase 'legally obligated to pay as damages' or 'liability imposed by law' refers to the liability of the insured arising from the breach of a duty that exists independent of any contractual relationship between the insured and the injured party. The breach of a duty imposed by law gives rise to an action sounding in tort.

Finally, Long states that:

Liability insurance protects the insured against damages which he may be liable to pay to other persons by virtue of his own actions. One might say that liability insurance protects the insured against the monetary consequences of his own tortious conduct as is addressed in the policy.

However, Long goes on to qualify this statement by observing that liability insurance is designed to indemnify the insured for "damage or destruction of property of others arising out of accidents or occurrences in business, professional, or personal life." Thus, after his broad statement, Long comes full circle back to the key to the determination of coverage, that is, the actual terms of the policy which provide coverage for property damage arising out of an occurrence.

The broad observations of Ostrager, Newman and Windt are supported by citations to the case law described above which espouse the rule that there is no coverage for economic damages arising out of a breach of contract. Again, these cases do not address a claim where there has been property damage caused by an occurrence as should be the case with many defective work claims.

Windt himself, for all the breadth of his sweeping pronouncement of the no coverage for breach of contract rule, recognizes its limits. In that connection, later in the same section of his treatise, Windt states:

The question also arises as to how far the 'no coverage for breach of contract rule,' set forth above, can be extended. It has been held that a negligence claim is not covered if it arises out of a breach of contract. The foregoing rule is not justifiable. *If there has been an occurrence and property damage, and no exclusion applies, there should be coverage.*

Windt at 228.

Within the insurance industry, the landmark commentary by George H. Tinker on the 1973 CGL policy form revisions makes clear the intent of the drafters that breach of contract damages are within the purview of the CGL insuring agreement. He states as follows:

The coverage agreement embraces ‘all sums which the insured shall become legally obligated to pay as damages. . . .’

That portion of the coverage grant is intentionally broad enough to include the insured’s obligation to pay damages for breach of contract as well as for tort, within limitations imposed by other terms of the coverage agreement (e.g., bodily injury and property damage as defined, caused by an occurrence) and by the exclusions . . .

George H. Tinker, “Comprehensive General Liability Insurance — Perspective and Overview,” 25 *Fed. Ins. Coun. Q.* 217, 265 (1975).

More recent commentary agrees:

The expression ‘legally obligated’ connotes legal responsibility that is broad in scope. It is directed at civil liability, rather than criminal liability, the latter being against public policy to insure. Civil liability can arise from either unintentional (negligent) or intentional tort, under common law, statute, or contract.

Donald S. Malecki & Arthur L. Flitner, *Commercial General Liability*, p. 6 (6th ed. 1997).

Finally, other commentators make it clear that the focus should not be upon the cause of action asserted, or vague legal principles, but the facts of the claim and the terms of the policy:

Liability for breach of contract should qualify under the ‘legally obligated’ qualification of the insurance clause absent disqualification under some other term or provision of the policy. [Footnote omitted.] That is, the legal theory under which the claim against the insured is pursued, namely breach of contract, should have little or no relevance to a determination of coverage. Rather, coverage should turn on whether the claim fits within the terms of the policy. [Footnote omitted.]

Scott C. Turner, *Insurance Coverage of Construction Disputes*, § 6.8 (2d ed. 1999). Moreover:

A frequent source of confusion in the field of insurance coverage interpretation has to do with whether causes of action which sound solely in breach of contract are covered by a CGL policy. *The confusion is compounded when the issue is discussed generically (i.e., without reference to policy language).* Unfortunately, certain courts have added to the confusion by rendering decisions without reference to policy language. *Simply stated, whether breach of contract is covered depends, not on the nature of the cause of action, but whether there was ‘bodily injury’ or ‘property damage’ caused by an ‘occurrence,’ and not otherwise excluded. . . .* It is true that most breach of contract cases are not covered under the CGL policy, but that is because there is no ‘occurrence’ or ‘property damage,’ not because the cause of action sounded in breach of contract. While a few cases have seemingly been

decided on the general basis of whether breach of contract is covered, a review of those cases would indicate that they would have been better decided on a traditional analysis of whether there was ‘occurrence’ or ‘property damage’. [Emphasis added.]

Edward J. Zulkey, 3 *CGL Reporter*, p. 310-8, 9 (1983).

These authorities illustrate the problems which occur when a court, rather than applying the terms of the policy, relies upon general principles, principles not supported by the language of the insuring agreement. Application of ironclad rules based upon vague principles causes cases to be decided without regard to the particular facts of a defective work claim, and coverage may be improvidently denied out of hand, rather than be analyzed from the standpoint of traditional CGL coverage. Of course, such a denial, based upon the proposition that a breach of contract does not give rise to liability for damages for which the insured is “legally obligated,” appears to be contrary to of the ordinary meaning of “legal obligation.” Most developers, owners and contractors expect that an obligation arising out of breach of contract is as legally enforceable as a liability arising out of breach of a tort duty. In *Vandenberg*, the California Supreme Court validated that expectation.

E. Texas Law on Coverage for Breach of Contract

Texas law on coverage for allegations of breach of contract is somewhat unsettled. The most recent reported opinion (and the only state court opinion) to discuss CGL coverage for a contractor’s breach of contract is *Continental Casualty Co. v. Major Constructors*,, 2000 Tex.App. LEXIS 4800 (Tex.App.–Houston [14th Dist.] July 20, 2000). In that case, Major, the insured was the prime contractor on a NASA construction project during which one of its subcontractors accidentally caused water damage to a building at the Johnson Space Center. Major requested Continental, its CGL carrier, to reimburse NASA for the damages. Continental refused, maintaining that pursuant to the CGL policy it was only required to pay sums that Major became legally obligated to pay as damages. Even though no one claimed that Major was at fault for the damage, Major contended it was nevertheless “legally obligated to pay” NASA for the damage pursuant to its contract. NASA instituted collection procedures pursuant to the Federal Acquisition Regulations. One of Continental’s major contentions was that the insured’s legal obligation could only be established by judgment, which ignored the fact that liability of the United States government contractors is determined administratively and not by judgment. On appeal, the court reversed the summary judgment on behalf of Major and affirmed the denial of Continental’s cross-motion. It remanded the case to the trial court, inviting the parties to develop the record in order to clear up issues of material fact as to Major’s obligations under its contract with NASA. That case is currently on remand and once the second round of motions for summary judgment are decided, it will no doubt be appealed.

It should be noted that the Fourteenth District Court of Appeals declined to even cite prior case law purporting to apply Texas law on these issues, *Data Specialties, Inc. v. Transcontinental Ins. Co.*, 125 F.3d 909 (5th Cir. 1997). Since the opinion was issued, it has been infrequently relied upon, particularly after the California Supreme Court’s decision in *Vandenberg* which overturned

virtually all of the case law which the Fifth Circuit relied upon in *Data Specialities*. Even though *Vandenberg* now casts doubt on the viability of the *Data Specialities* case, it should not be ignored.

Data Specialities, Inc. (“DSI”) was an electrical contractor specializing in disaster reconstruction projects involving data processing systems and was performing reconstruction work at a plant which had been severely damaged during torrential rains in Dallas, Texas. When the reconstruction project was nearly complete, an explosion occurred, seriously injuring a DSI electrician, and causing extensive property damage to equipment which was already installed. As a result of the explosion, DSI was required to repair and rebuild portions of the electrical system, paying for the property damage and extended overhead. The damage claimed by DSI included smoke and water damage to the electrical system, much of which had to be replaced. DSI reported the claim to its liability carrier, Transcontinental, which denied the claim, taking the position that the costs of repair and replacement did not constitute sums which DSI was legally obligated to pay. Transcontinental virtually conceded that the fire and explosion constituted a classic occurrence under the CGL policy resulting in property damage to the electrical system. Moreover, only a minor portion of the property damage, damage to one defective switchboard out of which the explosion occurred, was excluded under Exclusions j(5) and (6). These exclusions denied coverage for the particular part of the property upon which DSI was performing operations and out of which the property damage arose and which was to be restored, repaired or replaced because the named insured’s work was incorrectly performed upon it.

Lacking a basis to deny the claim on more traditional grounds such as the definition of occurrence or property damage, or the “work product” exclusions, Transcontinental argued that DSI was seeking recovery of its own out-of-pocket expenses arising from the explosion since no party claimed that DSI was potentially at fault for the explosion. Transcontinental further argued that the DSI expenditure was made merely to preserve DSI’s reputation and good business relationship with Haggar.

Curiously, the court stated that “whether DSI had a contractual obligation to complete additional work following the work following the explosion” was a moot issue in light of lack of coverage. *Id.* at 910. Nevertheless, the court went on to analyze coverage for DSI in terms of tort versus contractual liability. Finding no Texas law on point,² the court relied on what it considered to be scholarly authorities, as discussed above. It also placed primary reliance on the *International Surplus Lines, supra*, line of cases from California, and specifically cited *Ritchie v. Anchor Cas.* As a result, it held that since there was no allegation of tortious activity on the part of DSI, the damages claimed by DSI amounted to additional expenditures to complete its contract and were not suffered

² In *Gibson & Associates, Inc. v. Home Ins. Co.*, 966 F.Supp. 468 (N.D. Tex. 1977), the court, in the context of a discussion of “occurrence” observed that jurisdictions have held that general liability policies ordinarily do not encompass coverage for damages arising from the insured’s breach of contract. However, that discussion arose in the course of the court’s ultimate determination that the claim did not involve property damage, only a claim for economic damages. Thus, it did not squarely address the issue set out in *Data Specialities*, that is, whether a breach of contract which involves an occurrence of property damage may be covered under a CGL policy.

by a third party. Thus, the CGL policy did not afford coverage in that situation. *Id.* at 913. In reaching its conclusion that a CGL policy covers only tortious conduct, and not conduct in breach of contract, the court failed to apply the recognized exception to the “no coverage for breach of contract” rule which states that the rule does not apply where there has been actual property damage resulting from an occurrence. Rather, the California case law upon which it relied addressed situations not involving occurrences of property damage in the sense of defective work claims.

In the Fifth Circuit’s defense, the facts before the court obviously influenced the outcome. The court denied coverage for the breach of contract of DSI because (a) the parties had stipulated that the insured was not at fault and there was no negligence alleged; (b) no lawsuit was filed against the insured; and (c) no demand was made to the insured contractor to repair or pay the damages. While these facts may appear peculiar to insurers or insurance practitioners, many claims involving defective work arise in this manner where defective workmanship causes an occurrence of property damage which the contractor is obligated to repair under its contract.

This is the primary backdrop against which the “contract versus breach of contract” battle is waged. In fact, many of these claims arise in the context of an insured contractor’s repair of property damage caused by an occurrence in order to *avoid* a breach of contract. In response to such claims, many carriers take the position that unless and until the insured is actually sued, there is no possibility of a “legal obligation” for it to defend against, let alone pay indemnity. This line of argument appears shortsighted. It is unclear why a contractual obligation cannot satisfy the “legally obligated to pay as damages” requirement in the CGL insuring agreement. At least one Texas court has addressed a similar issue in *Texas Prop. & Cas. Ins. Guar. Ass’n v. Boy Scouts of America*, 947 S.W.2d 682 (Tex.App. – Austin 1997, no writ). In that case, the Boy Scouts sought coverage from the Texas Property & Casualty Insurance Guaranty Association (“Texas Guaranty”) for a settled claim following insolvency of their liability carrier. In defending against the claim for coverage, Texas Guaranty argued that the trial court erred in granting the Boy Scouts summary judgment because the Boy Scouts were not “legally obligated” to pay the claim which they had settled. The court stated as follows:

To make this argument, Texas Guaranty relies on language in the 1985 Mission insurance policy stating that Mission agreed to ‘pay on behalf of the [Boy Scouts] all sums which the [Boy Scouts] shall become legally obligated to pay as damages on account of . . . personal injuries’ (Emphasis added.) By statute, Texas Guaranty assumes the policy obligations of Mission to the extent that those obligations are ‘covered claims.’ [Citations omitted.] Texas Guaranty argues that it is not obligated to pay any amount for the Post claim [the settled claim] unless the Boy Scouts can prove that the Boy Scouts itself was legally obligated to pay the settlement on the Post claim.

Id. at 690-91.

Thus, Texas Guaranty argued that the term “legally obligated to pay as damages” requires a judgment against the insured and that the insurance policy provided no coverage for a contractual obligation. The Austin Court of Appeals refused to accept that argument, stating:

What Texas Guaranty fails to recognize, however, is that a court judgment is not the only manner by which the Boy Scouts could become legally obligated to pay the Post claim. A legal obligation can also arise out of a contract, such as a settlement. Therefore, Mission was ‘legally obligated’ to indemnify the Boy Scouts for covered claims, whether the legal obligation was fixed by judgment or by settlement contract.

Id.

The *Boy Scouts of America* case specifically addresses whether a contract can give rise to damages which the insured is legally obligated to pay and appears to hold that no adjudication is necessary, and that a contract can give rise to a liability for which there is coverage under a liability policy. Moreover, the *Boy Scouts of America* holding is not necessarily limited to settlement agreements.

In this manner, *Boy Scouts of America* is in accord with other Texas law, which states that the term “contract” implies enforceable legal obligations. *Plains Cotton Co-op Assn. v. Wolf*, 553 S.W.2d 800 (Tex. Civ. App. – Amarillo 1977, writ ref’d n.r.e.). As the *Vandenberg* court held, the ordinary meaning of a “legal obligation” is that it includes *both* liability in tort *and* in contract. For example, Black’s Law Dictionary, Fifth Edition (1991), provides the following relevant definitions:

Legal duty — An obligation arising from contract of the parties or the operation of the law . . . *Id.* at 804.

Legally liable — Liability imposed by law or liability which law fixes by contract. *Id.* at 806.

Legal right — Natural rights, rights existing as a result of contract, and rights created or recognized by law. *Id.* at 807.

These authorities indicate that in its plain meaning, the term “legally obligated” includes contractual obligations and that there is no policy requirement for an adjudication to render a contractual obligation binding.

F. The Construction Contract as Legal Obligation

Of course, there is room for considerable disagreement between insureds and insurers, or at least their counsel, as to whether a contractual provisions renders an insured “legally obligated” to incur damages because of property damage arising out of an occurrence. To hold that a contract does not create a legal obligation would appear to require an insured contractor to sit back and wait for the other party to sue it, usually the owner, for breach of contract. Obviously, this is not a preferred way to run a construction business, or any business for that matter, and unduly penalizes the contractor which fulfills its contractual obligations, and in the process, undoubtedly mitigates damages for all concerned, including its insurer.

In *Vandenberg v. Superior Court*, the California Supreme Court addressed the issue of whether a judgment against an insured for breach of contract which involved an occurrence of property damage is covered under a CGL policy. However, the California Supreme Court has not ruled, in light of *Vandenberg*, whether a CGL carrier is obligated to pay a claim against an insured where that claim has not been reduced to judgment.

In *Certain Underwriters at Lloyds v. Superior Court (Powerine Oil Co.)*, 75 Cal.App.4th 1038, 89 Cal.Rptr.2d 706 (1998), a California Court of Appeals held that an insured has no objective reasonable expectation that a CGL policy will provide coverage for amounts spent to comply with environmental administrative orders and to investigate and clean up contaminated sites. In that case, Powerine's insurers denied coverage based upon *Foster-Gardner, Inc. v. National Union Fire Ins. Co.*, 18 Cal.4th 857, mod. at 19 Cal.4th 53e, 77 Cal.Rptr.2d 107, 959 P.2d 265 (1998), in which the California Supreme Court held that a liability insurer's obligation to defend a "suit" did not create a duty to defend an administrative environmental proceeding. In response, the insured argued that under *Vandenberg v. Superior Court, supra*, no ordinary person would understand that the phrase "legally obligated to pay as damages" means that coverage is available if an environmental agency memorializes a cleanup in a consent decree in court but is barred if the agency uses an equally binding administrative environmental remediation order. Although not the precise issue, this case may have some impact on whether a claim based upon a contractual obligation which has not been reduced to judgment is covered under a CGL policy.

In *Powerine*, the California Supreme Court will decide whether a CGL insurer's duty to indemnity includes administratively ordered cleanup and remediation costs where no actual judgment has been entered against the insured. The *Powerine* case is still being briefed by the parties and *amici curiae* to the California Supreme Court. *Certain Underwriters at Lloyds v. Superior Court of the State of California for the County of Los Angeles (Powerine Oil Co., Real Party-in-Interest)*, No. S084057 (Cal. 1999), as reported in the February 22, 2000 issue of *Mealey's Litigation Reporter: Insurance*.

IV. EXCLUSION (b) AND BREACH OF CONTRACT

Often, Exclusion (b), the "contractual liability" exclusion, is cited as a basis to deny coverage for a defective work claim involving breach of contract. That exclusion, together with the accompanying definition, provides as follows:

Exclusion:

The insurance does not apply to:

- (b) '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 that the ‘bodily injury’ or ‘property damage’ occurs subsequent to the execution of the contract or agreement. Solely for the purpose of liability assumed in an ‘insured contract’, reasonable attorney fees and necessary litigation expenses incurred by or for a party other than an insured are deemed to be damages because of ‘bodily injury’ or ‘property damage’, provided:
 - (a) Liability to such party for, or for the cost of, that party’s defense has also been assumed in the same ‘insured contract’; and
 - (b) Such attorney fees and litigation expenses are for defense of that party against a civil or alternative dispute resolution proceeding in which damages to which this insurance applies are alleged.

Definition:

‘Insured contract’ means:

* * *

- f. 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.

The insurer relied upon this exclusion in *Federated Mut. Ins. Co. v. Grapevine Excavation, Inc.*, 197 F.3d 720 (5th Cir. 1999), more fully discussed in Section II of this paper. There, causes of action for negligence, breach of contract and indemnity, among others, were made by the general contractor against the insured paving subcontractor which was alleged to have installed defective fill in a parking lot. The court held that the exclusion was not applicable in a situation where the insured was sued for its own breach of contract, not solely for assumption of liability of a third party. The court’s explanation is worth quoting at length:

This exclusion operates to deny coverage when the insured assumes responsibility for the conduct of a third party. As GEI is not being sued as the contractual indemnitor of a third party’s conduct, but rather for its own conduct, the exclusion is inapplicable. Moreover, even if the contractual liability exclusion were somehow applicable to situations in which the insured is being sued for its own conduct, the exclusion would not apply here. It is true, as Maryland notes, that under the subcontract between GEI and T&S, GEI agreed to indemnify T&S and hold it harmless for claims arising both from conduct of specified third parties and from its own conduct. Accordingly, Maryland urges, GEI’s alleged liability to T&S is ‘by reason of the assumption of liability in a contract or agreement’ and therefore excluded from coverage. This indemnity provision is not, however, the only source of GEI’s

duty to T&S. Even absent a contractual indemnity provision, GEI would be liable to T&S – under generally applicable contract law – for damage caused by GEI’s negligent failure to perform its contractual duties according to the specifications in the subcontract. There are, therefore, at least two sources from which GEI’s liability to T&S could spring and only one of them could be deemed an assumption of liability. When, as here, liability could be imposed pursuant to either a contractual indemnity provision or a generally applicable legal principle, the contractual liability exclusion will not bar coverage. For the forgoing reasons, we conclude that the contractual liability does not apply. [Footnotes omitted.]

Id. at 726-727. For a case following this same line of reasoning, see *E&R Rubalcava Constr., Inc. v. The Burlington Ins. Co.*, 2000 WL 680401 (N.D. Tex. May 25, 2000) (contractual liability exclusion did not apply in breach of contract and negligence action brought by general contractor against concrete subcontractor).

As can be seen, these types of arguments have not been successful, largely because the exclusion is recognized as applying only to liability *assumed* under contract, that is pursuant to a hold harmless or indemnity agreement, rather than *breach* of contract. *Tinker, supra* at 265. See also, *Olympic, Inc. v. Providence Washington Ins. Co.*, 684 P.2d 1008, 1011 (Alaska 1982) (“liability assumed by the insured under any contract refers to liability incurred when one promises to indemnify or hold harmless another, and does not refer to liability that results from breach of contract.”) Of course, pursuant to the accompanying definition, an indemnity agreement constitutes an “insured contract” if the named insured assumes the tort liability of another to pay for property damage to a third party or organization. Tort liability means a liability which would be imposed by law in the absence of any contract or agreement.

Another Texas case addressing the contractual liability exclusion, this time for contractually assumed liability of a third party, is *Gibson & Associates, Inc. v. Home Ins. Co.*, 966 F.Supp. 468 (N.D. Tex. 1997), where a contractor sought a declaration that its CGL carrier breached its duty to defend the contractor against claims made against it by the city of Dallas. The city sued the contractor for breach of contract and indemnity arising out of financial losses to business owners due to the closing of a downtown street during construction. The indemnity claim was based upon the city’s allegation “that the contractor ‘contracted and agreed to indemnify and save harmless the defendant, City of Dallas, from and against any and all claims, lawsuits or any other harm for which recovery of damages is sought, that arise out of a breach of any term of the contract by third party defendant [the contractor].’” *Id.* at 476. The CGL policy contained a standard exclusion for contractually assumed liabilities except for those assumed under an insured contract, defined as one in which the insured assumes the tort liability of another.

The insurer argued that there was no coverage for the indemnity obligation running from the contractor to the owner since the agreement was based in contract and that CGL policies provide coverage only for tort-based liability. The court found that this reasoning misconstrued the nature of the indemnity obligation, that is the assumption by contract of the liability of another which is distinct conceptually from the breach of one’s contract with another. Liability assumed under contract is triggered by contractual performance, while breach of contract is triggered by contractual

breach, citing *Musgrove v. Southland Corp.*, 898 F.2d 1041 (5th Cir. 1990), applying Louisiana law. The court concluded that since the insurer had agreed to provide coverage for the third party tort liabilities assumed in an insured contract, the insured contractor was entitled to a defense against the indemnity claim as long as that claim was otherwise covered by the policy.

The court stated:

The claims asserted against it [Gibson, the contractor] by the Shop Owners, however, sought to hold the City liable not for breach of contract, but rather for negligence and unconstitutional deprivations of property. [Footnote omitted.] Clearly, the mere fact that the City's indemnification action against Gibson arise from the parties' contractual relationship does not convert the Shop Owners' tort-based causes of action against the City into breach-of-contract claims.

* * *

Consequently, as the Shop Owners' actions do in fact include causes of action that sound in tort, and as the City's third-party complaints allege that Gibson agreed to assume all such liability if it was caused by a breach of contract on Gibson's part, the Court finds that the indemnification clause constitutes an 'insured contract' not exempted from coverage by exclusion (b).

Id. at 479.

Thus, for purposes of Exclusion (b), the focus is on the allegations made against the third party seeking indemnity, not the contractual indemnity claim of the indemnitee against the insured. As such, Exclusion (b), dealing only with the assumption of liability pursuant to an indemnity clause, should not frequently come into play in a breach of contract claim, unless the claim for which the indemnitee seeks coverage is itself a breach of contract claim. If so, as set out above, the starting point for analysis is whether that breach of contract claim involves property damage caused by an occurrence.

V. THE "NO COVERAGE FOR BREACH OF CONTRACT" RULE CONFLICTS WITH OTHER EXCLUSIONS IN THE CGL POLICY

An insurance policy, such as a CGL policy, has a basic structure. First, the insuring agreement, including the coverage grant, provides for a broad scope of coverage which is then narrowed by the policy definitions and exclusions. Finally, exceptions to the exclusions may restore coverage otherwise denied pursuant to the exclusions. If the "legally obligated to pay as damages" portion of the CGL insuring agreement is read so as not to include coverage for breach of contract damages, other exclusions in the policy which are directly applicable to those types of claims are rendered unnecessary. For example, Exclusion (m) excludes coverage for property damage to impaired property or property that has not been physically injured arising out of "a delay or failure by you [the named insured] or anyone acting on your behalf to perform a contract or agreement in accordance with its terms." If damages for breach of contract were not within the scope of the insuring agreement, this portion of Exclusion (m) should not be necessary.

Moreover, Exclusion (l) excludes coverage for property damage to “your work,” that is, the named insured’s work, arising out of it or any part of it and included in the “products-completed operations hazard” unless the damaged work or the work out of which the damage arises was performed on the named insured’s behalf by a subcontractor. One of the criteria in the policy for determining whether the named insured’s work is complete for purposes of the products-completed operations hazard is “when all of the work called for in your contract has been completed.” Apparently, the fact that a contractor’s work has been performed under a contract will not deprive it from coverage under the products-completed operations hazard. Of course, it goes without saying that an insured contractor’s liability for property damage will almost always involve liability in contract. Under Exclusion (l), and its predecessor, Exclusion (z) in the Broad Form Property Damage Endorsement, a contractor is entitled to coverage for property damage to and arising out of work performed by a subcontractor.

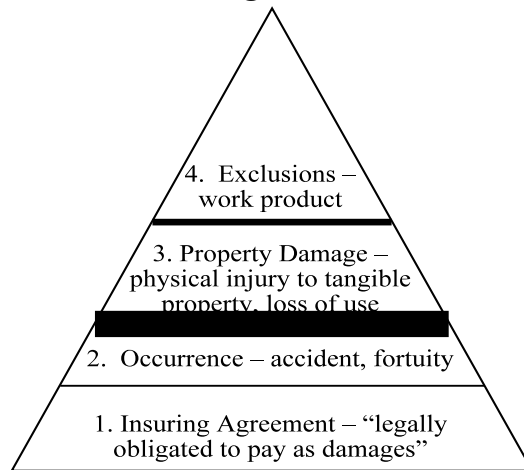
See, Fireguard Sprinkler Systems v. Scottsdale Ins. Co., 864 F.2d 648 (9th Cir. 1988); *Mid-United Contractors, Inc. v. Providence Lloyds Ins. Co.*, 754 S.W.2d 824 (Tex. App. – Fort Worth 1988, writ denied); *Maryland Cas. Co. v. Reeder*, 221 Cal.App.3d 961, 270 Cal.Rptr. 719 (1990). *Contra: Bor-Son Building Corp. v. Employers Commercial Union Ins. Co. of America*, 323 N.W.2d 58 (Minn. 1982); *Knutson Constr. Co. v. St. Paul Fire & Marine Ins. Co.*, 396 N.W.2d 229 (Minn. 1986) (1973 BFPD exclusion). *But see, O’Shaughnessy v. Smuckler Corp.*, 543 N.W.2d 99 (Minn. App. 1996), *pet. for rev. den’d* (Minn. 1996) (upholding subcontractors’ work exception to Exclusion (l) under 1986 CGL policy form and distinguishing *Bor-Son v. Commercial Union* and *Knutson v. St. Paul Fire & Marine*).

Based on these cases, there would be no point in including an exception to Exclusion (l) distinguishing between an insured contractor’s and its subcontractors’ work, or between ongoing or completed operations in the event coverage for all breach of contract liability was never contemplated for coverage in the insuring agreement. Thus, coverage for a particular breach of contract must be analyzed under the terms of the entire CGL policy. The claim involving property damage within the purview of the insuring agreement may not be disposed of simply through citation to an overly broad rule relating to breach of contract.

In this regard, see Figure 1 set out below. The pyramid represents the basic steps in interpreting and analyzing coverage for a claim under a CGL policy. First, the insuring agreement, including the requirement that the insured be “legally obligated to pay as damages,” is located at the base of the pyramid because the insuring agreement is intended to set out the very broadest statement of coverage under the policy. That broad grant of coverage is then narrowed by the definitions of occurrence (with its accident and fortuity requirements) and property damage (with its physical injury to tangible property and loss of use requirements) at upper levels of the pyramid. This location represents the fact that these definitions narrow the coverage provided in the insuring agreement. Finally, the work product exclusions applicable to a defective work claim are at the top of the pyramid. These exclusions are included to deny coverage for certain claims which, even though they may involve property damage caused by an occurrence for which the contractor is legally obligated, nevertheless are outside the intended coverage.

The pyramid illustrates the fact that if coverage for defective work claims, or any other claim for that matter, is denied at the outset because of a wooden application of a rule that breach of contract liability does not constitute a covered “legal obligation” of the insured, then a greater number of claims than intended are denied and other portions of the policy, particularly the definitions of occurrence, property damage and the work product exclusions are rendered superfluous. In that case, the CGL policy is of much less utility to a contractor, and those other parties on a construction project, such as the owner or developer, which depend upon it to provide coverage for property damage arising out of the contractor’s defective work.

**Policy Interpretation
Figure 1**



CGL COVERAGE FOR BREACH OF CONTRACT 2000 UPDATE

Supplemental Materials

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