CONSTRUCTION INSURANCE UPDATE: NEW CASES AND A FEW "WHAT IFS"

Houston Bar Association
Construction Law Section

April 20, 2017

Patrick J. Wielinski

COKINOS

New Cases for Today

- Damages for Insurance Code violations
- Underlying attorneys fees awards
- Actual trial requirement to bind insurer
- Exclusive remedy under CIPs

“What ifs” for Today

- Esoteric approaches to property damage – rip and tear
- Your Work versus Your Product coverage defenses

Damages for Insurance Code Violations:
USAA v. Menchaca

USAA v. Menchaca

- *USAA Texas Lloyds Co.* v. *Menchaca*, 2017 WL 1311752, --- S.W.3d --- (Tex. Apr. 7, 2017)
- Hurricane Ike homeowners' claim, USAA declined to pay any benefits because their estimate was under the deductible
- Insured sued for breach of contract and for unfair settlement practices in violation of the Texas Insurance Code
- As damages, insured sought only benefits under the policy
- Jury found:
    1. USAA did not fail to comply with the policy; *but*
    2. USAA did "fail to pay a claim without conducting a reasonable investigation;" and
    3. USAA failed to pay benefits it "should have paid"
- Jury awarded insured $11,350. Court of appeals affirmed.

USAA v. Menchaca

What the Court did in *Menchaca*:

- Texas Supreme Court clarified the type of damages available for extra-contractual claims under the Texas Insurance Code
- The circumstances under which those damages are available
- Acknowledged that previous precedent was confusing and seemingly contradictory

USAA v. *Menchaca*

The Primary Question:

Whether an insured can recover policy benefits as actual damages caused by an insurer's statutory violation absent a finding that the insured had a contractual right to the benefits under the insurance policy?

COKINOS

USAA v. Menchaca

COURT FORMULATED FIVE RULES:

- The General Rule
- The Entitled-to-Benefits Rule
- The Benefits-Lost Rule
- The Independent-Injury Rule
- The No-Recovery Rule

USAA v. Menchaca:

A. THE GENERAL RULE:

The insured cannot recover policy benefits as damages for an insurer's statutory violation if the policy does not provide the insured a right to receive those benefits

- Nothing new
- If it's not covered it's not covered

USAA v. Menchaca

B. THE ENTITLED-TO-BENEFITS RULE:

The insured who establishes a right to receive policy benefits can recover benefits as actual damages under the Insurance Code if the insurer's statutory violation causes the loss of the benefits

- Eliminates two common insurer arguments:
  - The insured must show an independent injury to recover on ***any*** extra-contractual claim
  - Damages flowing from the independent injury are the only damages available for ***any*** extra-contractual claim.

COKINOS

USAA v. Menchaca

C. THE BENEFITS-LOST RULE:

Even if the insured cannot establish a present contractual right to policy benefits, the insured can recover benefits as actual damages under the Insurance Code if the insurer's statutory violation caused the insured to lose that contractual right

- This is the sea-change
- Makes clear that the “no extra-contractual claims in the absence of a breach of contract” is no longer a viable argument
- Also expressly applies to claims based on waiver and estoppel: makes clear that statutory claims are still viable even when insured’s claim is based solely on a waiver/estoppel theory

COKINOS

USAA v. Menchaca

D. THE INDEPENDENT INJURY RULE:

If the insurer's statutory violation causes injury independent of the loss of benefits, the insured may recover damages for that injury even if the policy does not grant the insured a right to benefits

- Eliminates two common carrier arguments:
  - Insured must show an independent injury to recover on ***any*** extra-contractual claim
  - Damages flowing from the independent injury are the only damages available for ***any*** extra-contractual claim.

COKINOS

USAA v. Menchaca:

E. THE NO-RECOVERY RULE:

The insured cannot recover ***any*** damages based on an insurer's statutory violation if the insured had no right to receive benefits under the policy **and** sustained no injury independent of a right to benefits.

- Not a departure from well settled law
- If it's not covered it's not covered
- If you're not injured you're not injured

COKINOS

Underlying Attorneys Fees Awards

Mid-Continent Casualty Co. v. Petroleum Solutions

- *Mid-Continent Casualty Co. v. Petroleum Solutions, Inc.*, 2016 WL 5539895 (S.D. Tex. Sept. 29, 2016)
  - 80+ page tour de force on over 15 coverage issues
  - Underlying action and insurance coverage litigation span nearly 20 years
  - PSI constructs underground fuel tank system at a truck stop
  - Component part purchased from Titeflex fails and 20,000 gallons of gas leaks out
  - PSI seeks coverage from Mid-Continent, its CGL insurer.
  - Both believe Titeflex connector is faulty
  - Owner sues PSI, PSI third-parties in Titeflex who counterclaims
  - Judgment in favor of Titeflex on the counterclaim for fees, expenses and costs
  - Mid-continent denies coverage, including attorneys fees awarded to Titeflex

Mid-Continent Casualty Co. v. Petroleum Solutions

- Coverage litigation filed by PSI
- Titeflex's counterclaim and PSI's claim against Titeflex involve a manufacturer's duty to indemnify an innocent seller Under Chapter 82
- Court divides the attorneys fee recovery into three parts
  - Defense against owner's products liability claims
  - Defense against PSI's affirmative claim under Section 82.002
  - Prosecution by Titleflex against PSI of its Section 82.002(a) indemnity claim pursuant to Section 82.002(g)

Mid-Continent Casualty Co. v. Petroleum Solutions

As to the Section 82.002(a) indemnity claim:

- Section requires indemnity by manufacturer of a seller against loss arising out of a products liability action
- The term "loss" in § 82.002(a) is specifically defined in § 82.002(b) to include "court costs and other reasonable expenses, reasonable attorney fees, and any reasonable damages."
- Fees are recoverable as "damages" based on the definition of "loss" in that § 82.002(b) makes attorney's fees a part of the substantive cause of action for indemnity.
- Attorney's fees constitute compensatory damages and, as a result, are covered as damages under the policy.

Mid-Continent Casualty Co. v. Petroleum Solutions

As to attorney's fees awarded under § 82.002(g)

- "[a] seller is entitled to recover from the manufacturer court costs and other reasonable expenses, reasonable attorney fees, and any reasonable damages incurred by the seller ***to enforce the seller's right to indemnification under this section"***
- Not recoverable as damages "because of" "property damage" under a CGL policy
- Attorney's fee award under § 82.002(g) is analogous to § 38.001of the Texas Civil Prac. & Rem. Code, which is a fee-shifting provision
- Attorney's fees "are auxiliary to a substantive cause of action," and therefore, attorney's fees awarded under § 82.002(g) are not covered as damages under a CGL policy

Mid-Continent Casualty Co. v. Petroleum Solutions

- The reference to Chapter 38 and fee-shifting casts doubt as to the status of attorneys fee for breach of contract awarded in the underlying action as "damages because of" property
- Will be appealed after post-trial motions are completed On April 26
- Certification?

Binding the Insurer to Settlement of the Claim

Great American Insurance Co. v. Hamel

Great American Insurance Co. v. Hamel, 444 S.W.3d 780 Tex.App. – El Paso 2014, pet. Granted)

- Hamels, homeowners, hire TMB to complete their home
- Water infiltration after 5 years
- Great American insures TMB for five consecutive years
- Denies coverage based on manifestation trigger and EIFS exclusion

Great American Insurance Co. v. Hamel

- Trial of the construction case
  - Hamels agree to pursue only TMB, the company, and not Terry Mitchell, its owner, personally
  - Bench trial, Mitchell is represented and testified
  - Opening statements were presented
  - Witnesses were call by Hamels, some by TMB
  - Negligence finding and judgment entered for Hamel
  - Findings of Fact and conclusions of law submitted by Hamels are entered
  - After judgment TMB assigns claims against Great American

Great American Insurance Co. v. Hamel

- Trial of the coverage case
  - Great American denies coverage -- no actual trial under *State Farm v. Gandy;* EIFS exclusion; no "occurrence;" and failure to allocate the damages
  - Hamels file coverage action, breach of contract, declaratory judgment and Insurance Code violations
  - Court essentially retries the construction case with both parties calling witnesses
  - Judgment for the Hamels
  - Great American appeals

Great American Insurance Co. v. Hamel

- Appeal of the coverage case
  - Great American claimed that there was no "actual trial" as required by the CGL policy conditions
  - Appellate court determines that Great American breached its duty to defend
  - Rejected the argument that the manifestation trigger was the governing law at the time of the initial denial
  - Beach of the duty to defend precluded reliance on the actual trial policy defense

Great American Insurance Co. v. Hamel

- Appeal of the coverage case:
  - Insured being defended, settles without knowledge or consent of insurer and enters into a sweetheart deal – assignment of claim in exchange for a covenant from the plaintiff not to execute against the assets of the defendant, except for the proceeds of the insurance policy
  - Factors under *Gandy* that invalidate an assignment:

(1) the assignment is made prior to an adjudication of the plaintiff's claim against the defendant in a fully adversarial trial;

(2) the defendant's insurer has tendered a defense;

(3) and either (a) the defendant's insurer has accepted coverage or (b) the defendant's insurer has made a good faith effort to adjudicate coverage issues prior to the adjudication of the plaintiff's claim.

Great American Insurance Co. v. Hamel

- None of the *Gandy* factors were present in *Hamel:*
  - The assignment was not made prior to the adjudication of the claim in a fully adversarial trial, but occurred only after the judgment was entered favorably for the Hamels
  - Great American never tendered a defense to TMB
  - Great American neither (a) accepted coverage nor (b) made a good faith effort to adjudicate coverage issues prior to the adjudication of the Hamels' claim.

  - The case has been argued before the Supreme Court
    - Great American has admitted coverage existed

Exclusive Remedy and CIPs

Exclusive Remedy and CIPs

- A number of states extend exclusive remedy protection throughout the tiers of participants as to a wrap up that provides workers compensation insurance
- The law is considerably developed by Texas courts
  - Courts apply Section 406.123 of the Texas Labor Code providing that a general contractor and a subcontractor may enter into a written agreement under which the general contractor provides workers compensation insurance coverage to the subcontractor and the employees of the subcontractor
  - Such an agreement makes the general contractor the employer of the subcontractor and the subcontractor's employees

Exclusive Remedy and CIPs

- The Owner under an OCIP that provides workers compensation is a "general contractor" entitled to exclusive remedy protection – *Entergy Gulf States, Inc. v. Summers,* 282 S.W.3d 433 (Tex. 2009)
- The general contractor in an OCIP "provides" workers compensation to subcontractor employees as a conduit through the contract documents that amount to an agreement to provide workers compensation insurance – *H.C. Beck, Ltd. v. Rice*, 284 S.W.3d 349 (Tex. 2009)
- Where general contractor provides workers compensation insurance to subcontractors on the project, all lower tiers on that project are entitled to immunity from third party suits by injured employees – *Etie v. Walsh & Albert Co., Ltd.,* 135 S.W.3d 764 (Tex. App.– Houston [1st Dist.] 2004, pet. denied)
- *In TIC Energy & Chemical v. Martin,* 498 S.W.3d 68 (Tex. 2016), the court reiterates the applicability of the exclusive remedy to all participants in an OCIP, rejecting the argument that a contractual provision preserving the independent contractor status of the subcontractor eliminated the exclusive remedy defense.

Assault on Exclusive Remedy Under CIPs

- *Manhattan | Vaughn JVP v. Josefina Garcia, et al*; No. 01-16-00443-cv, In the First Court of Appeals, Houston, Texas
  - Kyle Field renovation project
  - Project insured by an OCIP
  - Employee of an enrolled demolition subcontractor operating a skid-steer goes over the edge and falls 70 ft. due to weight of the concrete in the skid-steer bucket
  - Survivors and estate file third party over action against Manhattan/Vaughn, the general contractor
  - The trial court denied Manhattan/Vaughn's motion for summary judgment based on Texas law extending the exclusive remedy under a CIP to all participating employers
  - Case proceeds to trial and a $54 million verdict is entered

Assault on Exclusive Remedy Under CIPs

- Manhattan/Vaughn was found 75% percent responsible and Lindemood, the demolition subcontractor, was 25% responsible
  - Post-verdict, the court found that Manhattan/Vaughn retained contractual control over the employee's work
  - The jury found that Manhattan/Vaughn exercised actual control over the "demolition work"

Assault on Exclusive Remedy Under CIPs

- Unclear why the trial court denied the motion
- No reasoned orders entered in Texas courts
- *Quid pro quo* – insured employer receives statutory immunity available for no fault coverage for employee's injury
- Unfair under a CIP?

- Plaintiffs are arguing that *H.C. Beck v. Rice* is to be distinguished on a close reading of dictum that the contractor there obligated itself to purchase workers compensation coverage if the OCIP folded

Assault on Exclusive Remedy Under CIPs

- AGC, ABC of Texas and Houston, TEXO, two brokers and ACIG (Vaughn's risk retention group) are sponsoring an amici curiae brief in the appellate court in support of Manhattan/Vaughn
  - Amici curiae brief is due in Mid-May
  - Will likely be appealed to the Supreme Court

Esoteric Property Damage Scenarios

COKINOS

Property Damage Esoterica

- Increasing variety of factual scenarios challenge the definition of “property damage”
  - “Physical injury to tangible property”
  - “Loss of use of property that has not been physically injured”
- Rip and Tear – New type of property damage?

U.S. Metals v. Liberty Mutual – Rip and Tear

- *U.S. Metals, Inc. v. Liberty Mutual Group,* Inc., 490 S.W.3d 20 (Tex. 2015)
  - Defective flanges supplied by insured are welded into place in refineries
  - One leaks, none meet spec. Replacement requires extensive damage to non-defective piping, insulation, etc.

U.S. Metals v. Liberty Mutual – Rip and Tear

- The court follows the majority rule that the incorporation of a defective product into a larger product in and of itself does not cause property damage
- But, in the context of the impaired property exclusion, the court makes a distinction between restoration to use versus replacement during repairs.
- The refineries were restored to use by the repairs so downtime was excluded as impaired property
- Insulation, gaskets, welds, coatings that were destroyed in the repairs were not "restored to use," but were destroyed and replaced and were not impaired property

U.S. Metals – Replacement of the Insured's Product or Work

- The court upheld coverage for the cost of ripping and tearing out non-defective work to repair or replace purely defective work
- Limiting coverage to property which cannot be restored to use, but which is destroyed in the process, appears to have created a third category of property damage
- May not be limited to the impaired property exclusion context

Esoteric Property Damage Scenario

- Insured contractor's employee performs nonconforming radiographic testing of welds in natural gas pipelines
- Results in multi-million dollar claim by owner for digging up and re-examining welds in completed pipelines
- Nothing blows up
- No claim for loss of use
- There are damages for costs of excavation and cutting out and replacing several welds among the hundreds re-examined
- Claim for anticipated damages excavating additional welds in the future

Esoteric Property Damage Scenario – CGL Issues

- Whether there is property damage
  - Physical injury to tangible property?
  - Life safety hazard?
  - No damages claimed for loss of use (Excluded?)
  - Rip and tear?
- Damages “because of” property damage
- When is time of occurrence?
- Number of occurrences

“Your Work” Versus “Your Product”

"Your Work" Versus "Your Product"

- Installation of systems or equipment blurs the distinction between the contractor's "work" and "product"
  - (At least in the eyes of denying insurers)
- Example:
  - Installation of PEX Piping by plumbing subcontractor
  - If it is the plumbing contractor's "product," there may be no coverage for damage to the work itself, even though performed by a subcontractor and occurring within the products-completed operations hazard
- *Building Specialties, Inc. v. Liberty Mutual Fire Ins. Co.*, 712 F.Supp.2d 628 (S.D. Tex. 2010) — piping as "discrete component"
  - If so, are all damages, including property damage to a home when removing the PEX piping, excluded damages as the cost of the repair of the insured's product?

"Your Work" Versus "Your Product" and the Real Property Exception

- Definition of "Your Product" in the contractor's policy applies to "any goods or products, ***other than real property***, manufactured, sold, handled, distributed or disposed of by" the named insured
- Recognizes that buildings are not manufactured, but built or erected
- *Wanzek Construction, Inc. v. Employers Insurance of Wausau*, 679 N.W.2d 322 (Minn. 2004) – coping stone around pool as real property, not a product
- Law of Fixtures
  - Personal property so affixed to the real property that it cannot be removed without substantial damage
  - *Houston Building Service, Inc. v. American General Fire & Casualty Co.*, 799 S.W.2d 308 (Tex. App. – Houston [1st Dist.] 1990, writ denied)

“Your Work” Versus “Your Product” – Another Example

- Defective fittings in HVAC system
  - Insured is supplier of entire VRF system
  - Insured in turn supplied defective fittings and pipes obtained from lower chain supplier
  - HVAC supplier is additional insured on fittings supplier’s policy
  - Better coverage than under its own policy, because only product that is excluded is the fittings and there is coverage for rest of system
  - Does the real property exception preserve coverage under HVAC supplier’s own policy?

Questions?

pwielinski@cokinoslaw.com

817-635-3620