



Vol. 23 No. 55

December 12, 2008

TEXAS HIGH COURT DECIDES WHEN INSURERS' DUTY TO DEFEND IS TRIGGERED

by

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In *Don's Building Supply, Inc. v. OneBeacon Insurance Co.*, the Texas Supreme Court recently addressed a long-standing open question in Texas insurance law. *See* -- S.W.3d --, 2008 WL 3991187, 51 Tex. Sup. C. J. 1367 (Tex. Aug. 29, 2008). For the first time, the Supreme Court clarified when property damage "occurs" for purposes of an occurrence-based commercial general liability insurance policy. "More specifically, is an insurer's duty to defend triggered where damage is alleged to have occurred during the policy period but was inherently undiscoverable until after the policy expired?"

FACTUAL BACKGROUND

Don's Building Supply, Inc. sells a synthetic stucco siding system known as Exterior Insulation and Finish System (EIFS). From December 1, 1993 to December 1, 1996, Don's installed this product on numerous homes. During that same timeframe, Don's was covered by comprehensive general liability policies issued by Potomac Insurance Company of Illinois and assigned to OneBeacon Insurance Company. From 2003 to 2005, various homeowners filed suit against Don's, alleging the EIFS was not weather-tight and allowed water intrusion into the wall cavities behind the siding causing wood rot and other damages.

The homeowners contended that the first penetration of water behind the EIFS began within six months to one year after the installation of the EIFS. However, in an attempt to not run afoul of the applicable statute of limitations, the homeowners further pled the discovery rule, a tolling mechanism in Texas law which, in certain circumstances, allows for the calculation of the statute of limitations from the date of discovery, rather than the date of actual injury. Thus, the homeowners claimed the damage was originally hidden from view and was not discoverable or readily apparent to someone looking at the exterior surface of the EIFS.

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In response to the homeowner suits, Don's sought a defense from OneBeacon under its commercial general liability policies. Initially, OneBeacon provided Don's a defense, but it eventually instituted a declaratory judgment action in federal district court to determine its defense and indemnity obligations under the policies. The federal district court ruled in favor of OneBeacon and held that the duty to defend and indemnify does not arise until the damage becomes identifiable. Don's appealed this decision to the Fifth Circuit. As the Texas Supreme Court had been silent on these questions, the Fifth Circuit certified the insurance coverage questions to the Texas Supreme Court.

FIRST CERTIFIED QUESTION

The first question from the Fifth Circuit to the Texas Supreme Court was: "When not specified by the relevant policy, what is the proper rule under Texas law for determining the time at which property damage occurs for purposes of an occurrence-based commercial general liability insurance policy?"

To begin its answer, the Court first outlined its well-established jurisprudence for insurance policy construction. Foremost, insurance policies are construed according to the same rules of construction that apply to contracts generally. To this end, the primary goal is to effectuate the parties' expressed intent. If the policy language is unambiguous, it will be enforced as written. However, if the policy language is ambiguous, any ambiguity must be resolved in the insured's favor. In addition, no individual phrase, sentence, or section of the policy should be considered apart from the other provisions, and the policy's words must be given their plain meaning.

Turning to the policy, it provided "bodily injury" and "property damage" coverage as follows:

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. We will have the right and duty to defend any "suit" seeking those damages.

The policy then stated:

This insurance applies to "bodily injury" and "property damage" only if:

- (1) The "bodily injury" or "property damage" is caused by an "occurrence" that takes place in the "coverage territory;" and
- (2) The "bodily injury" or "property damage" occurs during the policy period.

Finally, a number of policy definitions were outlined. An "occurrence" is "an accident, including continuous or repeated exposure to substantially the same general harmful conditions." "Property damage" is defined as "[p]hysical injury to tangible property, including all resulting loss of use of that property. All such loss of use shall be deemed to occur at the time of the physical injury that caused it[.]"

Reading these policy provisions together and for their plain meaning, the Texas Supreme Court held that property damage under this policy occurred when actual physical damage to the property occurred. “The policy says as much, defining property damage as ‘[p]hysical injury to tangible property,’ and explicitly stating that coverage is available if and only if ‘property damage occurs during the policy period.’” Thus, for this policy, the property damage occurred when the home suffered wood rot or other physical damage, not when that physical damage was or could have been discovered.

The Court then noted that Texas appellate courts have taken somewhat divergent views on when coverage is triggered and have employed no less than three different tests. In particular, a number of Texas courts have utilized the “manifestation rule” which imposes a duty to defend only if the property damage became evident or discoverable during the policy term. Although this was the approach urged by OneBeacon and followed by most Texas cases, the court simply concluded that the straightforward language of the policy makes no provision for it. “Whatever practical advantages a manifestation rule would offer to the insured or the insurer, the controlling policy language does not provide that the insurer’s duty is triggered only when the injury manifests itself during the policy term, or that coverage is limited to claims where the damage was discovered or discoverable during the policy period.” Finally, as a note of caution, the court stressed that it was not attempting to fashion a universally applicable rule for determining when an insurer’s duty to defend is triggered, as this determination must always be driven by the policy language.

SECOND CERTIFIED QUESTION

The second certified question from the Fifth Circuit stated: “Under the rule identified in the answer to the first question, have the pleadings in lawsuits against an insured alleged that property damage occurred within the policy period of an occurrence-based commercial general liability insurance policy, such that the insurer’s duty to defend and indemnify the insured is triggered, when the pleadings allege that actual damage was continuing and progressing during the policy period, but remained undiscoverable and not readily apparent for purposes of the discovery rule until after the policy period ended because the internal damage was hidden from view by an undamaged exterior surface?”

The Supreme Court answered “yes” to this question. Under the “eight corners” doctrine, a duty to defend is triggered if the plaintiff alleges facts that would give rise to any claim against the insured that is covered by the policy. Under the rule adopted in response to the first question, any claim against Don’s that the physical injury occurred during the policy period and was caused by Don’s allegedly defective product would trigger OneBeacon’s duty to defend. This duty is not impacted by whether or not the property damage was discoverable.

FINAL THOUGHTS

In this opinion, the Texas Supreme Court shed light on what has been a point of contention in numerous insurance coverage disputes. Insurers, insureds, and Texas appellate courts have long wrestled over what is the proper coverage-triggering moment. Perhaps the most enlightening outcome was the Court’s rejection of what had been considered the majority rule in Texas: the “manifestation rule.” Although the Court expressly couched its ruling in the language of the policy before it, due to the

similar, if not identical, language of many commercial general liability policy provisions and definitions, this opinion will likely be determinative in numerous future disputes. Although not universal, the Court's opinion should have a profound effect on an insurer by simply resolving some of the uncertainty and confusion Texas law has fostered regarding when coverage is triggered. By doing so, this should greatly improve an insurer's ability to accurately determine when coverage is triggered and thus, whether a duty to defend is owed.

As a further point, the Court also made one final suggestion which may be of some import to insurers. In short, by reaffirming its dedication to the parties' expressed intent in the policy, the Court indicated that the test for determining when coverage is triggered is, in essence, in the insurer's hands. If insurers believe another approach, such as the "manifestation rule," is preferable, they should tailor their policy provisions accordingly.

Finally, in terms of its impact outside of Texas, this opinion may prove persuasive elsewhere. Generally speaking, the majority of jurisdictions have similar rules of contract construction and much like Texas, seek to effectuate the expressed intent of the parties' agreement. As such, even though the opinion is not binding in other jurisdictions, these courts may nevertheless look to the reasoning of this opinion when construing similar insurance policies.