Texas Court Requires Insurer to Defend GC Despite Breach of Contract Exclusion

In *Mt. Hawley Insurance Co. v. Slay Engineering, et al.*,[1] a Texas federal court ruled in favor of a general contractor, finding that its insurer had a duty to defend it in a construction defect case filed by the owner. The decision adds more clarity to the interpretation of the subcontractor exception to the "Damage to Your Work" exclusion as well as the Breach of Contract exclusion, which has been the subject of several cases coming out of Texas over the past decade.

The coverage dispute between the general contractor, Huser Construction Company Inc., and its insurer, Mt. Hawley Insurance Company, arose from construction defect litigation involving a faulty swimming pool and the adjacent parking lot in a municipal sports complex for the City of Jourdanton. The complaint against Huser included breach of contract and negligence claims and alleged, among other things, defective work performed by Huser as well as its subcontractors and suppliers. Specifically, the City alleged substantial cracks in the swimming pool, parking lot, and deficient site drainage. Huser tendered the claim to Mt. Hawley, who denied both defense and indemnity and filed a declaratory judgment lawsuit against its insured.

The Mt. Hawley policies at issue contain industry standard provisions, requiring property damage caused by an occurrence and obligating the insurer to defend covered occurrences. Texas follows the majority of states in finding defective construction to be an occurrence. *See* SDV 50 State Survey. The Policies also contained two exclusions that Mt. Hawley cited in its denial of coverage: (1) the "Damage to Your Work" exclusion, which bars coverage for property damage to Huser's work, but contains an exception for work performed by a subcontractor; and (2) an endorsement which barred coverage for property damage arising directly or indirectly out of a breach of "express or implied contract, breach of express or implied warranty, or fraud or misrepresentation regarding the formation, terms or performance of a contract."

Mt. Hawley argued that the Breach of Contract Exclusion eliminated coverage for Huser because all of the City's allegations arose from the contract. The Court disagreed, concluding that the exclusion did not bar coverage for damages caused by Huser's subcontractors. The Court adopted the analysis from a California case, *Mt. Hawley Ins. Co. v. Aguilar*,[2] which interpreted the same exclusion in a similar Mt. Hawley policy. The Court found that the "directly or indirectly" and "arising out of" language required Mt. Hawley to demonstrate that Huser's breach of contract was a "but for" (though not necessarily proximate) cause of the alleged property damage. Notably, in Texas, when two separate events (one excluded and one covered) may independently have caused the accident, the general liability policy must provide coverage despite the exclusion. The fact that the construction defect allegations had some relation to Huser's contract with the City or that Huser had been sued for breach of contract were insufficient to trigger the Breach of Contract exclusion. Because there could have been an independent cause of the property damage other than Huser's breach of contract (e.g., the negligence of its subcontractors), the exclusion did not bar coverage.

In addition, Mt. Hawley argued that the "subcontractor exception" to the Damage to Your Work exclusion was eliminated by the Breach of Contract exclusion in that all subcontractors' work was incidentally related to Huser's breach of contract. Huser argued, and the Court agreed, that such an interpretation would be improper as it would require the Court to read the subcontractor exception out of the policy. For this conclusion, the Court again relied on the court's analysis from the *Aquilar* case where Mt. Hawley made the same argument.

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[1] No. 18-cv-252, 2018 WL 3946547 (W.D. Tex. Aug. 15, 2018).

[2] No. SACV 07-00969, 2008 WL 11342656 (C.D. Cal., Feb. 2, 2008).

Here, the Court elaborated that the Breach of Contract exclusion cannot be interpreted to encompass all work incidentally related to the project. If interpreted that way, it would render the subcontractor exception to the Damage to Your Work exclusion meaningless and also improperly require the Court to resolve any ambiguity in favor of the insurer.

The Court ultimately found that Mt. Hawley was required to defend Huser because the complaint contained claims which could "potentially be covered," which is the standard in Texas for triggering the duty to defend. In its rationale, the Court stated that because the City's complaint alleged defective work performed by Huser as well as its *subcontractors and suppliers*, the allegations that these other entities are responsible for the allegedly defective work and resulting damage suggest the property damage may have occurred even in the absence of a breach of contract by Huser.

This case provides a helpful clarification that Texas construes breach of contract exclusions narrowly and reaffirms that the subcontractor exception to the Damage to Your Work exclusion cannot be read out of the policy.

SDV will keep you updated regarding trends in construction related policyholder coverage cases.

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