

Uncertainty Remains Regarding the Contractual Liability Exclusion After the Texas High Court Declines to Clarify Its Holding in *Gilbert*

By David Taubenfeld¹

Gilbert Texas Construction, L.P. v. Underwriters at Lloyd's London is another one of those unfortunate Texas Supreme Court cases that will absolutely engender litigation as both carriers and insureds try to figure out what the Court meant to do and say.² On the one hand, the Court seems to eviscerate any notion that there can be coverage under a Commercial General Liability (CGL) policy for a claim denominated "breach of contract." On the other hand, the case stands for the proposition that poor Gilbert simply was not covered under the anomalous facts of the case. While logic and optimism support the latter reading, arguments can and will certainly be made for either reading.

Gilbert Texas Construction (Gilbert) was the general contractor on a project for the Dallas Area Rapid Transit Authority (DART). During the project, unusually heavy rains damaged the building adjacent to the construction site. The building's owner ("Neighbor") sued DART and its contractors, alleging that their construction activities damaged Neighbor's property. Neighbor sued Gilbert in tort and breach of contract. Gilbert won summary judgment as to the tort claims on the grounds of governmental immunity. Gilbert eventually settled the breach of contract claim and sought indemnity from its insurers. Gilbert's primary carrier exhausted its limits paying the settlement, and the excess carrier denied coverage based on the "Contractual Liability Exclusion" and refused to pay. The Texas Supreme Court ruled that the Contractual Liability Exclusion applied and that there was no coverage.

The Court originally decided *Gilbert* in June 2010, and its broad statements shook the insurance coverage and risk management communities to their core.³ The fear was that the Court's broad holdings could be interpreted to exclude coverage for all breach of contract causes of action. Gilbert filed a motion for rehearing, joined by numerous amici curiae. Both insureds and carriers hoped that the Court would at least clarify its holding after understanding its potential practical effects. In December 2010, the Court denied Gilbert's motion for rehearing but "substituted" a "new" opinion for its June 2010 opinion. Unfortunately, the substituted opinion makes no change to the most mystifying sections of the original opinion—it merely changes some of the wording in the Court's treatment of "waiver and estoppel." The analysis and results remain unchanged.

Background

DART contracted with Gilbert to build a light rail system. Among Gilbert's contractual undertakings was to protect the worksite and the surrounding property. When the adjacent building was flooded after unusually heavy rains, the building owner sued Gilbert in tort and as a third-party beneficiary of the DART-Gilbert contract. Gilbert submitted the claim for coverage to its primary carrier, Argonaut Insurance Company ("Argonaut"), and its excess carriers, Lloyd's of London ("Lloyds"). Argonaut assumed Gilbert's defense, and Gilbert selected Jim Grau from Argonaut's list of approved defense counsel to defend it. Lloyds issued generic reservations of rights letters. In its initial answer, Gilbert pleaded "sovereign

¹ David Taubenfeld is a partner in the Dallas, TX office of the law firm of Haynes and Boone, LLP. His practice emphasizes insurance coverage litigation and he represents policyholders in every kind of dispute they may have with their insurers. David may be reached at david.taubenfeld@haynesboone.com or 214.651.5531.

² *Gilbert Tex. Constr., L.P. v. Underwriters at Lloyd's London*, 327 S.W.3d 118 (Tex. Dec. 17, 2010).

³ *Gilbert Tex. Constr., L.P. v. Underwriters at Lloyd's London*, 53 Tex. Sup. J. 780 (Tex. June 4, 2010).

immunity" as a defense to liability. During the course of the pre-trial proceedings, Lloyds insisted that Gilbert seek summary judgment as to Gilbert's "sovereign immunity" defense. When Gilbert hesitated, Lloyds threatened to assert that Gilbert had violated the policy's cooperation clause if it did not move for summary judgment. Gilbert succumbed to Lloyds' pressure and moved for summary judgment. The trial court granted summary judgment in Gilbert's favor as to all of the plaintiff's claims except for the breach of contract claim. At that point, Lloyds amended its reservation of rights letter to add that the breach of contract claim was not covered because of Lloyds' Contractual Liability Exclusion.

The Lloyds policy states in relevant part that Lloyds "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 The 'bodily injury' or 'property damage' must be caused by an occurrence." The Contractual Liability Exclusion (Exclusion 2(b)) provides that the insurance does not apply to:

"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) Assumed in a contract or agreement that is an "insured contract;" or
- (2) That the insured would have in the absence of the contract or agreement.

The policy's definitions section provides a definition of "insured contract." The term is defined as seven types of agreements, the last of which is an agreement to assume another's tort liability:

"Insured contract" means:

- a. A lease of premises;
- b. A sidetrack agreement;
- ...
- g. that part of any other contract or agreement pertaining to your business under which you assume the tort liability of another to pay damages because of "bodily injury" or "property damage" to a third person or organization, if the contract or agreement is made prior to the "bodily injury" or "property damage." Tort liability means a liability that would be imposed by law in the absence of any contract or agreement.

After the trial court granted summary judgment as to all other claims, Gilbert settled the remaining claim for \$6.175 million and submitted the settlement to Lloyds for coverage. Lloyds denied the claim. As a result of Lloyds' denial, Gilbert sued Lloyds for breach of contract and Texas Insurance Code violations, also arguing that Lloyds waived its right to deny coverage and was estopped to deny coverage. Lloyds claimed that at the time Gilbert settled the lawsuit, the court had granted summary judgment as to all claims other than the breach of contract claim, so the only basis for Gilbert's liability was the obligations Gilbert had assumed under its contract with DART. Gilbert argued that the contractual liability exclusion was meant to apply only to liability **of another** that an insured had agreed to take on by contract. Gilbert argued that any other interpretation would eviscerate the Texas Supreme Court's holding in *Lamar Homes, Inc. vs. Mid-Continent Cas. Col.*, 242 S.W.3d 1 (Tex. 2007), in which the Court had held that a breach of contract claim can involve an occurrence and coverage does not turn on the label of the cause of action. Gilbert also contended that, alternatively, the exclusion is ambiguous, and must be interpreted narrowly in favor of coverage. Both parties moved for summary judgment in the trial court. That court granted Gilbert's motion as to coverage, and granted Lloyds' motion as to all extra-contractual claims.

On appeal, the court of appeals reversed and rendered judgment for Lloyds, holding that the breach of contract claim (1) fell within the policy's contractual liability exclusion and (2) was not excepted from the exclusion. It also determined that Lloyds had not waived nor was estopped to assert its policy defenses. Gilbert petitioned for review in the Supreme Court.

The Decision

The Supreme Court affirmed the court of appeals. First, the Court determined that it had jurisdiction to hear the appeal because of a conflict between the courts of appeal of the State. The conflict arose because the Houston court of appeals had held that the contractual liability exclusion applied only to liability assumed for conduct of a third party, such as in an indemnity or hold-harmless agreement.⁴ Here the court of appeals determined that the exclusion applied because Gilbert took on responsibilities ("assumed liability") in its contract with DART.

The Court considered the contractual liability exclusion and its two exceptions as a whole. It held that the contract provided that "the policy does not apply to 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, except for enumerated, specific types of contracts called 'insured contracts' and except for instances in which the insured would have liability apart from the contract. In this case, Gilbert agreed under its contract with DART to 'repair any damage to . . . facilities, including those that are the property of a third party, resulting from failure to comply with the requirements of this contract or failure to exercise reasonable care in performing the work.'" Thus, because the liability at issue was liability to Neighbor, and that liability was the subject of the contract with DART, the Contractual Liability Exclusion applied to it.

As to Gilbert's argument that the exclusion clearly applied only to liability of a third-party that an insured takes on by contract, the Court held that had the exclusion been intended to apply only to third party liability assumed by contract, it would have been simple to say so. "We can not 'rewrite the policy' so as to reflect what one party argues is the unexpressed intent of the contract." Using Webster's dictionary to supply the "ordinary" meaning of the policy's words, the Court determined that to "assume" means to "undertake." "Liability" is "[t]he quality or state of being legally obligated or accountable." Using these simplistic definitions, the Court held that Gilbert "undertook" to "be legally obligated" to safeguard Neighbor's property in its contract with DART, and so the exclusion applied.

The Court acknowledged that many courts, including the Federal Fifth Circuit Court of Appeals, had held that the exclusion applies to a limited category of cases in which the insured assumes the liability of another, such as in an indemnity or hold-harmless agreement. The Court disagreed "by and large," with the courts' and treatises' conclusions that the language of the contractual liability exclusion before it applied only to indemnity or hold-harmless agreements. Instead, it adopted the extreme minority reasoning that the exclusion may be applied to abrogate coverage merely because the allegations are that an insured did not do what it had agreed to do in a contract.

What about the exceptions to the exclusions? Gilbert argued that it would have been liable in tort "in the absence of the contract" because if the contract did not exist, it would not benefit from sovereign immunity and so it would be liable in tort. No!, the Court held. The Court acknowledged that Gilbert owed adjoining

⁴ See *Lennar Corp. v. Great Am. Ins. Co.*, 200 S.W.3d 651, 693 (Tex. App.—Houston [14th Dist.] 2006, pet. denied).

landowners the duty to comply with law and to conduct its operations with ordinary care so as not to damage the neighbors' property. The Court acknowledged that "absent its immunity (Gilbert) could be liable for damages it caused by breaching its duty." Because Gilbert had secured summary judgment, however, the Court determined that "Gilbert's only potential liability remaining in the lawsuit was liability in excess of what it had under general law principles. Thus, the neighbors' breach of contract claim was founded on an obligation or liability contractually assumed by Gilbert within the meaning of the policy exclusion." Despite the policy's clear language stating that the Exclusion did not apply to liability that Gilbert would have had "in the absence of the Policy," the Court held that the duty to indemnify must be determined by the actual facts adjudicated, and the only liability theory remaining when Gilbert settled with Neighbor was the breach of contract claim. To determine whether this exception applies, the Court held, we must decide whether Gilbert proved it would have had liability for Neighbor's damages absent its contractual undertaking. Gilbert argued that without the contract, it would not have been immune, and it would have been liable in negligence. The Court held that we have to take the facts as they are, and that since there was a contract and it lead to Gilbert's governmental immunity, Gilbert could not have been liable absent the contract. Even though case law establishes that the Court must interpret exceptions to exclusions broadly in favor of coverage, the Court held that there was no coverage.

Gilbert argued that if the exclusion can operate to exclude general breach of contract claims, then the Supreme Court's recent landmark opinion in *Lamar Homes* is eviscerated.⁵ The Court responded that the Contractual Liability Exclusion was not at issue in *Lamar Homes*. There the Court considered whether property damage to a house that resulted from construction defects could nevertheless come within the general terms of liability coverage because the damage resulted from an occurrence as defined by the CGL policy.

Finally, Gilbert argued that Lloyds was estopped to deny coverage because Lloyds essentially assumed control of Gilbert's defense and thus prejudiced Gilbert. Gilbert argued that Lloyds had failed to reserve its rights to deny coverage based on the Contractual Liability Exclusion, and then insisted that Gilbert's defense counsel file its motion for summary judgment on sovereign immunity grounds at a time when Lloyds knew that if the motion was successful, it would deny coverage. Lloyds had threatened to urge the "Cooperation Clause" to deny coverage if Gilbert did not accede to its wishes to seek summary judgment. The Court determined that the threat of the "Cooperation Clause" was not enough to be considered the actual assumption of the defense. Moreover, the Court held that although Lloyds had never included the Contractual Liability Exclusion in its reservation of rights letter, Lloyds had made clear that it did not believe that the breach of contract claim was covered, and so it had disclosed any conflict of interest relating thereto. Finally, in what can only be considered *dicta*, the Court determined that Gilbert had not been prejudiced in any event. The Court determined, essentially, that since at the end of the day, Gilbert was immune from tort liability, there was no coverage for the lawsuit and Gilbert could not have been prejudiced.

Conclusion

One thing is clear. *Gilbert* will be good for coverage lawyers. It has engendered and will continue to engender significant further coverage litigation as the bar sorts through what the Supreme Court did. On the one hand, the Court specifically stated that it was not holding that the Contractual Liability Exclusion precluded liability for all breach of contract claims. The case can be read as one in

⁵ See *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 242 S.W.3d 1 (Tex. 2007) (holding that a breach of contract claim can involve an "occurrence" under CGL policies and that the coverage does not turn on a cause of action's label).

which the unfortunate insured really could only be liable in contract, and because of that anomaly, fell within the exclusion. The problem is that the Court very specifically adopted a small minority view of the Exclusion when it determined that the Exclusion unambiguously excluded claims based on the insured's breach of its own contract. The vast majority of courts to have decided the same issue had concluded that the exclusion should be limited to situations in which the insured had contractually assumed the tort liability of a third party, often through an indemnity agreement.

Under the Court's logic, the only way to secure coverage for a breach of contract claim will be to fit within an exception to the exclusion. Sometimes, the contract at issue will fit within the policy definition of "Insured Contracts," and coverage will obtain. Many run-of-the-mill contract cases will **not** be based on "Insured Contracts," however. Sometimes, the insured would have liability apart from the contract, and coverage will obtain. This would occur more frequently if the inquiry actually embodied in the policy is employed: would the insured have tort liability "in the absence of the contract?" *Gilbert* would have been liable in negligence to Neighbor, and would not have enjoyed sovereign immunity "in the absence of the contract." Unfortunately, the Court's inquiry is "would the insured have liability 'apart from the contract?'" This question assumes the presence, rather than the absence of the contract, and led to a different result in *Gilbert*.

Hopefully, further decisions will clarify that *Gilbert* is meant only to apply to the anomalous facts of the case. In any event, it will be important, at least for a while, to make sure that allegations of tort claims are in and remain in all lawsuits against insureds.