

HOMEOWNER'S INSURANCE, INCLUDING THE LATEST INTERPRETATION ISSUES AND FORMS

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David L. Plaut**

Hanna & Plaut, L.L.P.
Attorneys at Law
106 East Sixth Street, Suite 520
Austin, Texas 78701
(Phone) (512) 472-7700
(Fax) (512) 472-0205
<http://www.hannaplaut.com>

BIOGRAPHY FOR DAVID L. PLAUT

David L. Plaut is a partner with the Austin law firm of Hanna & Plaut, L.L.P. Mr. Plaut graduated from Johns Hopkins University with honors in 1985 and the University of Texas School of Law in 1989. He was articles editor of the Texas Law Review and served as a briefing clerk for United States District Judge Edward Prado in San Antonio for two years before beginning private practice. His practice focuses on insurance coverage matters, insurance "bad faith" litigation, trial and appellate work. He is admitted to practice before the United States District Courts for the Northern, Southern, Eastern, and Western Districts of Texas, as well as the United States Court of Appeals for the Fifth Federal Circuit.

Mr. Plaut's publications include

- *Bad Faith Litigation in Texas and Update of Recent Extra-Contractual Cases*, Handling Insurance and Tort Claims (Univ. of Houston 1999);
- *Hot Topics in Homeowner's Insurance: Including Balandran and Insurance Coverage for Residential Foundation Claims*, Insurance Law in Texas (Lorman Education Services) (May 25, 1999);
- *Trinity v. Cowan: Mental Anguish Is Not "Bodily Injury" and Intentional Torts are Not "Accidents,"* 61 Tex. B.J. 128 (February 1998);
- *Gandy Busts Up Sweetheart Deals For Good*, 60 Tex. B.J. 1112 (December 1997);
- *The Duty To Defend and State Farm v. Gandy*, Insurance Bad Faith Claims Seminar (Oct. 17, 1997);
- *Statutory Bad Faith Update*, Insurance Bad Faith Claims Seminar (Oct. 17, 1997);
- *Obtaining or Avoiding Summary Judgment in a Bad Faith Case: The "Bona Fide Dispute" Standard for Assessing an Insurer's Handling of a Claim*, 3rd Annual Advanced Issues in Insurance "Bad Faith" Litigation (Oct. 13, 1995);
- *Lyons v. Millers Casualty: The Last Word on the Standard for Assessing Bad Faith in Texas?*, 57 Tex. B.J. 832 (Sept. 1994);
- *A Guide to the Local Rules of Texas Federal Courts*, 54 Tex. B.J. 604 (June 1991) (co-authored).

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HOMEOWNER'S INSURANCE, INCLUDING THE LATEST INTERPRETATION ISSUES AND FORMS

I. INTERPRETATION OF INSURANCE CONTRACTS IN TEXAS

A. General Rules of Construction

Interpretation of insurance policies is governed by the same rules that govern interpretation of other contracts. *Forbau v. Aetna Life Ins. Co.*, 876 S.W.2d 132, 133 (Tex. 1994). The court primarily seeks to give effect to the written expression of the parties' intent. *Id.* It must read all parts of the contract together and "must be particularly wary of isolating from its surroundings or considering apart from other provisions a single phrase, sentence, or section of a contract." *State Farm Life Ins. Co. v. Beaston*, 907 S.W.2d 430, 433 (Tex. 1995) (citing *Forbau*, 876 S.W.2d at 133-34). The plain language of an insurance policy will be given effect -- even with respect to exclusionary language -- "when the parties' intent may be discerned from that language." *Glover v. National Ins. Underwriters*, 545 S.W.2d 755, 761 (Tex. 1977); *see also Hofland v. Firemans Fund Ins. Co.*, 907 S.W.2d 597, 599 (Tex. App.—Corpus Christi 1995, no writ) (holding that an exclusion should be accorded its plain, grammatical meaning unless it definitely appears that the intention of the parties would thereby be defeated).

If a written contract is worded so that it can be given a definite or certain legal meaning, it is not ambiguous. *National Union Fire Ins. Co. v. CBI Industries, Inc.*, 907 S.W.2d 517, 520 (Tex. 1995); *Coker v. Coker*, 650 S.W.2d 391, 393 (Tex. 1983). Whether a contract is ambiguous is a question of law for the court to decide. *CBI Industries*, 907 S.W.2d at 520; *Coker*, 650 S.W.2d at 394; *see also Temple-Inland Forest Products Corp. v. United States*, 988 F.2d 1418, 1421 (5th Cir. 1993) (under Texas law, interpreting an unambiguous contract presents a question of law). Mere disagreement by the parties as to the meaning of a provision of an agreement does not create an ambiguity. *Beaston*, 907 S.W.2d at 433 ("Both the insured and the insurer are likely to take conflicting views of coverage, but neither conflicting expectations nor disputation is sufficient to create an ambiguity"); *see also Matlock v. Nat'l Union Fire Ins. Co.*, 925 F. Supp. 468, 472 (E.D. Tex. 1996).

If no ambiguity exists, the court will enforce the policy in accordance with its plain meaning. *National Union Fire Ins. Co. v. Kasler Corp.*, 906 F.2d 196, 198 (5th Cir. 1990) (emphasizing that "special rules favoring the insured are only applicable where there is an ambiguity in the policy; if the term in question is susceptible to only one reasonable construction, then these rules do not apply"); *Yancey v. Floyd West & Co.*, 755 S.W.2d 914, 918 (Tex. App.—Fort Worth 1988, writ denied) (citing *Puckett v. U.S. Fire Ins. Co.*, 678 S.W.2d 936, 938 (Tex. 1984)). Only where a contract is first determined to be ambiguous may the courts consider extraneous evidence. *CBI Indus.*, 907 S.W.2d at 520; *Mustang Tractor & Equip. Co. v. Liberty Mutual Ins. Co.*, 76 F.3d 89, 91 (5th Cir. 1996) (parol evidence of intent is admitted to explain an ambiguity in an agreement, but never to create the ambiguity). An insurance policy term is "ambiguous" when it is reasonably susceptible to more than one construction.

A plaintiff seeking recovery under an insurance policy must prove only those provisions that allow recovery. *See Texas Farmers Insurance Co. v. Murphy*, 996 S.W.2d 873, 879 (Tex.

1999); *Paragon Sales Co. v. New Hampshire Ins. Co.*, 774 S.W.2d 659, 661 (Tex. 1989) (per curiam). If there are any contractual provisions that could limit or bar recovery, it is incumbent on the insurer to plead and prove them. *See id.* Although Texas courts generally “striv[e] to give meaning to every sentence, clause, and word to avoid rendering any portion inoperative,” *Balandran*, 972 S.W.2d at 741, an insurer who does not plead or prove any applicable exclusionary provision waives the effect of that provision. *See Murphy*, 996 S.W.2d 879; *Paragon Sales*, 774 S.W.2d at 661.

B. “Judicial Tiebreakers” for Assessing Contract Meaning

Despite an apparent preference for the contra-insurer rule discussed below, courts often resort to “judicial tiebreakers,” many of which are venerable Latin maxims which give judges a chance to pretend they took Latin in high school (and probably makes the law clerks wish they had). All too often these maxims provide an occasion for using rhetoric rather than analysis.

1. Specific terms control over general terms

Specific provisions usually take precedence over general language. In this vein, handwritten terms generally get deference, followed by typewritten terms, which take precedence over preprinted forms. *Melvin Green, Inc. v. Questor Drilling Corp.*, 946 S.W.2d 907, 909 (Tex. App.–Amarillo 1997, no writ); *O’Connor v. O’Connor*, 694 S.W.2d 152, 155 (Tex.App.–San Antonio 1985, writ ref’d n.r.e.); *Bright v. New York Life Ins. Co.*, 546 S.W.2d 145, 146 (Tex. Civ. App.–Corpus Christi 1977, writ ref’d n.r.e.). This rule of interpretation follows from the idea that where the parties have focused on a given portion of text, this portion should have greater weight than conflicting language largely overlooked by the parties.

2. *Expressio Unius Est Exclusio Alterius*

The maxim *expressio unius est exclusio alterius* (“the expression of one thing is the exclusion of another”) means more or less what a literal translation suggests. *Southern County Mut. Ins. Co. v. Smith*, 529 S.W.2d 618, 620 (Tex. Civ. App.–Tyler 1975, no writ); *Boger & Boger v. Continental Fire & Cas. Ins. Corp.*, 234 S.W.2d 133 (Tex. Civ. App.–Dallas 1950, writ refused n.r.e.) (maxim defined to mean “the expression in a contract of one or more things of a class implies exclusion of all things not expressed, even though all would have been implied had none been expressed”). If, for example, an insurance policy contains a specific discussion of a formula for assessing the cost of repairing a dwelling, one could reasonably apply *exclusio alterius* to decide that the term “amount of loss” as used in the policy meant the cost of repair rather than replacement cost or market value. Stempel, *Interpretation of Insurance Contracts* § 3.4.

3. *Ejusdem Generis*

The maxim *ejusdem generis* (“of the same kind”) is used where a contract contains a grouping of items. *Decorative Center v. Employers Cas.*, 833 S.W.2d 257, 260 (Tex. App.–Corpus Christi, 1992, writ denied) (*ejusdem generis* principles draw on the sensible notion that words such as “or other invasion of the right of private occupancy” are intended to encompass

actions of the same general type as, though not specifically embraced within, “wrongful entry or eviction”); *Jones v. St. Paul Ins. Co.*, 725 S.W.2d 291, 294 (Tex. App.–Corpus Christi 1986, no writ) (because the general words of the exclusion (earth movement) preceded and did not follow the specific words (earthquake, landslide, mudflow) the doctrine of *ejusdem generis* did not apply). For example, a homeowner’s insurance policy could provide coverage of all personal property but exclude antiques, heirlooms, and art. If the policyholder lost his collection of original letters from Sam Houston to William Barrett Travis instructing Travis to destroy the Alamo, the insurer could argue, probably with success, that the valuable historical documents were like antiques or heirlooms in that they possessed a value beyond ordinary household personal property and that the insurer did not assume this risk.

4. *Noscitur a Sociis*

Courts occasionally use the maxim *noscitur a sociis* (“it is known from its associates”) for the same or similar constructive purpose: deciding whether the term in question is similar or dissimilar to the items unquestionably within the contract. *Maddox v. Flato*, 423 S.W.2d 371, 377 (Tex. Civ. App.–Corpus Christi 1967, writ ref’d n.r.e.) (the rule or maxim of *noscitur a sociis*—it is known from its associates—permits the interpretation of a word by reference to the meaning of words that are associated with or related to it).

5. *Ut Res Magis Valeat Quam Pereat*

Another Latin phrase with some clout is *ut res magis valeat quam pereat* (“that the thing may rather have effect than perish”), which in our vernacular means that courts should try to construe contracts so that they will be legal and enforceable in some manner so long as such interpretation does not unduly strain the text. Stempel, *Interpretation of Insurance Contracts* §3.4.

6. *Contra Proferentem*: The Contra-Insurer Principle

The most important Latin phrase in the interpretation of insurance contracts, is *contra proferentem* (“against the author”). *Contra proferentem* or the contra-insurer principle provides that ambiguous contract language is construed against the party that drafted the language, on the theory that the drafter was the person in the best position to avoid the ambiguity. *Contra proferentem* has become a first tier interpretive vehicle in insurance contract litigation. One commentator has characterized the approach as “a tool of substantive policy that is intended systematically to favor the weaker party,” which is almost always the policyholder. Barry R. Ostrager & Thomas R. Newman, *Handbook on Insurance Coverage Disputes* § 1.03[B][1] (1988). Once an insurance policy term is labeled “ambiguous,” invocation of the doctrine becomes a nearly automatic finding in favor of the insured. See Jeffrey W. Stempel, *Interpretation of Insurance Contracts* §5.1 (1994). But see *GTE Mobilnet of South Texas Ltd. Partnership v. Telecell Cellular, Inc.*, 955 S.W.2d 286 (Tex. App.–Hous. [1st Dist.]1997, writ denied) (*contra proferentem* is to be applied as interpretive aid “only as a last resort”).

Strictly speaking, however, insurance companies in Texas do not “draft” the standardized policies issued, but provide insurance on forms specifically adopted and approved by the Texas Department of Insurance (“TDI”). Despite the fact that insurance companies have no authority to

vary insurance forms approved for use by the TDI, courts have repeatedly applied the contra-insurer principle in the highly regulated insurance context. *See, e.g., Balandran v. Safeco Ins. Co. of Am.*, 41 Tex. Sup. Ct. J. 1155, n.1 (noting that “[t]his widely followed rule is an outgrowth of the general principle that uncertain contractual language is construed against the party selecting that language”). The contra-insurer principle also reflects an implicit recognition of the adhesive nature of insurance contracting and the practical strength of the insurer in the typical transaction. *See id.* (noting that the rule is also justified by “the special relationship between insurers and insureds arising from the parties’ unequal bargaining power”). Contra-insurer principles also facilitate risk distribution and probably mask what is really a naked invocation of “public policy,” normally the last resort in matters of contract interpretation.

II. SOIL BEHAVIOR AND THE PROBLEM OF FOUNDATION SETTLEMENT

Sinking foundations, cracked and buckled walls, and uneven floors are problems commonly faced annually by a quarter-million homeowners across the country. Micro-Flo Industries, *Indications of Foundation Settling Problems* (July 1998). Homes and other structures situated on unstable soils may settle downward or heave upward when their foundation are subjected to extreme moisture conditions or lack proper drainage. A shifting foundation may result in structural damage to the home and a loss of the homeowner’s investment.

The typical home has two foundations. The first and most important foundation is the soil on which the man-made structure rests. Movement of the soil beneath the home can severely damage its second foundation of concrete and steel, even though it may be well designed and sturdy. Certain kinds of soil have better stability than others: they move around less, don’t swell as much when they get wet, or shrink and crack as much when they are dry. Much of the foundation litigation in Texas involves concrete slabs constructed on clay soils. The climate in Texas is such that these clay soils shrink and swell, depending upon the length of dry spells and the amount of rain.

Soils have the ability, in varying degrees, to take in and give up water. For example, when water is applied to sand very little water is absorbed; sand does not expand or increase in volume as much as clay soils, which absorb a great deal of water. When dried out, sand does not compact or shrink as much as clay. A clay soil, when subject to a changeable climate, is going to expand and shrink and the house sitting on it is going to rise and settle intermittently. If the climate is always wet, with rain distributed uniformly throughout the year, or if the climate is consistently dry, as in a desert-like environment, a house is going to be more stable and less likely to suffer damage.

The soil which is most likely to swell and shrink, resulting in damage to the home, is called expansive clay. Some clay soils, when saturated with water from heavy rains or from long soaking of flower beds and shrubs around the edge of the house, will expand up to twice their dry volume. When the soil swells it moves the house upward. During dry spells those soils lose their moisture content and shrink, and the house settles back. If this occurs unevenly, (one area of the soil under the house gets more water or dries out faster), the house will be twisted and strained and frequently will sustain damage. Homeowner’s insurance policies in Texas have uniformly excluded coverage for “settlement” damage of this sort.

III. BALANDRAN AND COVERAGE FOR FOUNDATION DAMAGE

A recent case, *Balandran v. Safeco Insurance Company of America*, 972 S.W.2d 738 (Tex. 1998) presented the Texas Supreme Court with the following question certified from the United States Court of Appeal for the Fifth Circuit:

Whether [Exclusion 1(h)] of the 1991 Texas Standard Homeowner Policy -- Form B excludes from coverage damage to a dwelling caused by a movement of its foundation that was caused by an underground plumbing leak.

In a 7-2 decision authored by Chief Justice Phillips, and joined by Justices Gonzalez, Enoch, Spector, Baker, Abbot, and Hankinson, the court held that Exclusion 1(h) does not apply to loss caused by the accidental discharge, leakage or overflow of water or steam from within a plumbing, heating or air conditioning system or household appliance. 972 S.W.2d at 739. Relying on *Sharp v. State Farm Fire & Casualty Insurance Co.*, 115 F.3d 1258 (5th Cir.1997), Justice Owen filed a dissenting opinion in which Justice Hecht joined. *Balandran* brings this round of foundation coverage litigation to a close and permits insureds to resume litigating the inevitable questions of causation that arise in these cases. As discussed below, *Balandran* does not address Exclusion 1(k), the “earth movement” exclusion, and this coverage issue remains to be litigated in the future.

A. Factual Overview

The Balandrans’ home was insured by Safeco under the 1991 Texas Standard Homeowner’s Policy. They filed a claim with Safeco for damage to their home caused by movement of their foundation. An underground plumbing leak had apparently caused the soil to expand, which damaged the foundation and the home’s interior and exterior finishes. Safeco denied coverage on the ground that the policy did not cover the insureds’ claim. The Balandrans sued Safeco in state court, but the carrier had the case removed to federal district court. 972 S.W. 2d at 739.

A jury determined that the plumbing leak caused structural damage to the home and awarded the Balandrans \$66,500. Safeco moved for judgment notwithstanding the jury’s verdict on the ground that the policy excluded coverage for this structural damage regardless of the cause. The district court granted the motion and entered a take-nothing judgment in favor of Safeco and the Balandrans appealed. While the appeal was pending before a panel of the Fifth Circuit, another panel in *Sharp v. State Farm Fire & Casualty Insurance Co.*, 115 F.3d 1258 (5th Cir. 1997), determined that an identical policy did not provide coverage for foundation damage from a plumbing leak. The Texas Commissioner of Insurance subsequently issued a bulletin rejecting the Fifth Circuit’s decision in *Sharp*. As a result, the panel hearing the Balandran’s appeal certified the question of coverage to the Texas Supreme Court. 972 S.W.2d at 739.

B. The Balandrans’ Arguments in Favor of Coverage

The Balandrans' policy provided two types of coverage. "Coverage A" insures the dwelling itself, while "Coverage B" insures personal property. Coverage A provides the following protection:

We insure against all risks of physical loss to the [dwelling] unless the loss is excluded in Section I Exclusions.

The exclusion relevant to this case is 1(h), which provides:

We do not cover loss under Coverage A (Dwelling) caused by settling, cracking, bulging, shrinkage, or expansion of foundations, walls, floors, ceilings, roof structures, walks, drives, curbs, fences, retaining walls or swimming pools.

We do cover ensuing loss caused by collapse of building or any part of the building, water damage or breakage of glass which is part of the building if the loss would otherwise be covered under this policy.

The Balandrans argued that language in Coverage B (the personal property section of the policy) created an exception to Exclusion 1(h) when the structural damage results from a plumbing leak. They also asserted that Exclusion 1(h) did not apply to structural damage resulting from an underlying cause -- in this case a plumbing leak -- which itself is not an excluded peril under the policy. Finally, the Balandrans argued that the last sentence of Exclusion 1(h) (the "ensuing loss" provision) created an exception to Exclusion 1(h). The Texas Supreme Court held in favor of the Balandrans on their first coverage argument and, as a result, did not address the other two. *Id.* at 740.

C. Safeco's Arguments in Favor of Coverage

Safeco had argued that the damage to the Balandrans' home clearly fell within Exclusion 1(h), the "settlement" exclusion. Relying on the structure of the policy, Safeco had argued that the "exclusion repeal provision" applies only to personal property losses resulting from a plumbing leak. Because Coverage B deals with personal property coverage, Safeco asserted that the "exclusion repeal provision" should be similarly limited. Safeco maintained that the "exclusion repeal provision" could not be construed without considering its context within the policy. In this regard Safeco relied on the Fifth Circuit's decision in *Sharp v. State Farm Fire & Casualty Insurance Co.*, 115 F.3d 1258 (5th Cir.1997). Under identical facts, the Fifth Circuit held that the damage to the dwelling was excluded under Exclusion 1(h), and that the exclusion repeal provision applied only to personal property losses. *See* discussion of *Sharp* below.

D. The Texas Supreme Court Accepts the Balandrans' "Exclusion Repeal Argument"

Unlike Coverage A, which insures the dwelling against "all risks," Coverage B insures personal property only against twelve enumerated perils. 972 S.W.2d at 740. The ninth of these twelve perils is:

Accidental Discharge, Leakage or Overflow of Water or Steam from within a plumbing, heating or air conditioning system or household appliance.

A loss resulting from this peril includes the cost of tearing out and replacing any part of the building necessary to repair or replace the system or appliance. But this does not include loss to the system or appliance from which the water or steam escaped.

Exclusions 1.a through 1.h under Section I Exclusions do not apply to loss caused by this peril.

Id. Even though Coverage B deals with personal property loss, which the Balandrans did not suffer, the Balandrans relied heavily on the last sentence quoted above. They argued that this provision -- which they refer to as an “exclusion repeal provision” -- means that Exclusions 1(a) through 1(h) do not ever apply to a loss caused by a plumbing leak. The Texas Supreme Court accepted the Balandrans’ argument and found that the exclusion repeal provision, on its face, applied to any “loss” -- including Coverage A dwelling losses -- not just personal property losses.

The court determined that the Balandrans’ interpretation of the policy was reasonable. First, the policy on its face states that Exclusion 1(h) does not apply to “loss” caused by a plumbing leak; this repeal of Exclusion 1(h) was not expressly limited to “personal property loss.” The court determined that the placement of the “exclusion repeal provision” in Coverage B did not support Safeco’s reading of the policy. Emphasizing that “the exclusion repeal provision could be located under Coverage B simply because that is the only place in the policy that the ‘accidental discharge’ risk is specifically described,” the court determined that it was logical for the “exclusion repeal provision” to be adjacent to the accidental discharge risk in Coverage B. *Id.* at 741.

The Court found that Safeco’s construction of the policy would render a part of the policy language meaningless. The exclusion repeal provision applies to “[e]xclusions 1.a. through 1.h.” Under Safeco’s reading, Exclusions 1(a) through 1(h) would have been repealed only for personal property losses caused by a plumbing leak. Emphasizing that Exclusion 1(h) on its face applies only to damage to the dwelling, the court noted that “if Safeco’s reading is correct, it would have been unnecessary to extend the exclusion repeal provision to exclusion 1(h), because that exclusion can never affect personal property losses.” *Id.* The court clearly viewed Safeco’s approach as rendering the part of the exclusion repeal provision referring to Exclusion 1(h) as without any effect.

E. Consideration of “Surrounding Circumstances”?

In addition to the standard rules of construction, the Texas Supreme Court emphasized that a “contract may be read in light of the surrounding circumstances to determine whether an ambiguity exists.” *Id.* (citing *Columbia Gas Transmission Corp. v. New Ulm Gas, Ltd.*, 940 S.W.2d 587, 589 (Tex.1996); *National Union*, 907 S.W.2d at 520)). The Court emphasized that the Balandrans’ argument became “even more reasonable” when it considered the circumstances surrounding the promulgation of the policy form. These circumstances included (1) the adoption

of the easy-to-read homeowner's form in 1990, which was not supposed to restrict coverage in any manner; and (2) the fact that the "exclusion repeal provision" in the 1978-1990 policy applied to both dwelling and personal property loss. *Id.* *Balandran* should not be viewed as departing from the longstanding principle of contract law that "parol evidence is not admissible to create an ambiguity." The reference to "surrounding circumstances" probably reflects the court's attempt to buttress a decision that is out of line with the Fifth Circuit.

F. *Balandran* Dissent Emphasizes the Sharp Decision

In her *Balandran* dissent, Justice Owen emphasized that the language of the standard Texas homeowner's policy was correctly interpreted by the United States Court of Appeals for the Fifth Circuit in *Sharp v. State Farm Fire & Cas. Ins. Co.*, 115 F.3d 1258 (5th Cir. 1997). Applying Texas law, the Fifth Circuit had held that the policy unambiguously excludes coverage for losses to the dwelling caused by foundation "settling, cracking, bulging, shrinkage or expansion" when such foundation movement is itself caused by a leak from within a plumbing system. 115 F.3d 1261-62. Justice Owen criticized the *Balandran* majority for ignoring "the structure of the policy" and for being "unduly swayed" by the arguments of the commissioner of insurance. *Balandran*, 972 S.W.2d at 743 (Owen, J. dissenting).

IV. THE NICOLAU DECISION

State Farm Lloyds v. Nicolau, 951 S.W.2d 444 (Tex. 1997) involved a disagreement among engineering and foundation experts about the cause of foundation movement that resulted in structural and cosmetic damage to the home of Ioan and Liana Nicolau, State Farm insureds. The Nicolaus' experts concluded that a plumbing leak had caused the foundation to heave with resulting damage to the Nicolaus' house. State Farm's expert examined the leak, evaluated the soil samples and other data collected by the insureds' experts and concluded that the leak did not cause the foundation movement. The Supreme Court, however, found that there was some evidence that could have led the jury to conclude that State Farm's reliance on its expert was unreasonable and/or that the expert's opinion was not objectively prepared. 951 S.W.2d at 448-450.

In *Nicolau*, the parties agreed that the policy at issue excluded losses caused by "inherent vice," such as a construction or foundation defect, and by foundation movement, with the exception of losses caused by accidental discharge or leakage from a plumbing system. State Farm's claims superintendent, in fact, "acknowledged that the Nicolaus' policy would cover any foundation settlement caused by a plumbing leak." *Id.* at 452.

A. Underlying Facts

The Nicolaus' foundation problems began in 1984 when they noticed cracks in the walls of their house. The Nicolaus lived in Corpus Christi, where many homes are built on expansive clay soil. 951 S.W.2d at 456 (Hecht, J., dissenting). Their own expert testified that many of the homes on the Nicolaus' street had similar cosmetic problems resulting from soil conditions. *Id.* at 457 (Hecht, J., dissenting). The Nicolaus hired a foundation repair contractor (Krismer) and a structural engineer with Maverick Engineering (Bacon), who concluded that the front of the

foundation was sinking due to excessive drying of the soil caused by drought and trees in the front yard. Krismer installed piers under the front of the house to stabilize the foundation. In 1988 the Nicolaus again noticed walls cracking, but Krismer, Bacon, and another foundation repair person hired in 1989 all concluded that the piers were performing normally and the front of the foundation was stable.

In late 1989, however, Krismer's inspection showed that the back of the house was some five inches higher than the front, resulting in significant cracking in the sheetrock and exterior brick as well as other damage. *Id.* at 446-447. Bacon then referred the matter to another engineer at his company, Fred Hayden, and together they determined that the foundation movement was due to "swelling of the soil at the *back* of the house rather than contraction of the soil at the front of the house." *Id.* at 447 (emphasis in original). Theorizing that excessive moisture under the foundation could cause the clay soil to expand, they tested for and detected a leak somewhere in the plumbing system. This was the first time a plumbing leak was suspected and the first time such tests were conducted. *Id.*

The Nicolaus filed a claim with State Farm in February 1990. A leak detection firm hired by State Farm located the leak in a sewer line towards the front of the house and an adjuster hired by State Farm expressed doubts that the leak at the front of the house was responsible for the foundation damage. (There is no indication that State Farm or its adjuster investigated the possibility of another leak at this time). *Id.* Maverick engineering, however, provided the Nicolaus with a report that concluded that the plumbing leak could have caused the foundation heaving if the leaking water had flowed along the lines and trenches towards the rear of the house. Ralph Cooper, State Farm's claims superintendent, then hired Haag Engineering to give a second opinion. (Cooper was aware at the time that Haag was "of the general opinion that a localized leak beneath the house would not cause foundation movement as a general rule." *Id.* at 448-49.) Haag's report concluded that the reported sewer leak did not significantly affect the foundation. *Id.* at 447. (Haag did not examine the leaking pipe, take core samples, or perform other tests of its own.) State Farm then denied the Nicolaus' claim based on the "inherent vice" and "foundation" exclusions, but paid for the reimbursement of expenses in locating and repairing the leak. *Id.* The Nicolaus subsequently forwarded a report from Tetco, another engineering firm, which concluded that, based on soil samples, the leak had allowed water travel through the cushion sand layer beneath the foundation, causing widespread wet conditions in the soils. *Id.* After reviewing the report, however, Haag disagreed and stated that their initial opinion had not changed. *Id.*

B. Procedural Overview

The Nicolaus then sued State Farm for breach of contract and extra-contractual claims. The jury found that State Farm breached the contract, engaged in unfair or deceptive practices, maliciously breached its duty of good faith and fair dealing and knowingly engaged in unconscionable conduct. The jury awarded \$102,200 in policy benefits for repairs, \$50,000 for mental anguish, \$300,000 in punitive damages and attorneys fees. The trial court, however, disregarded the extra-contractual findings and entered judgment for breach of contract and attorneys fees. *Id.* at 795. The court of appeals affirmed the breach of contract finding and

reversed and rendered judgment on the extra-contractual claim in accordance with the jury's findings. *Nicolau v. State Farm Lloyds*, 869 S.W.2d 543, 555 (Tex. App.–Corpus Christi 1993).

C. Supreme Court Decision

The plurality opinion of Justice Spector affirmed the “bad faith” judgment because there was allegedly some evidence that State Farm’s expert’s report was not objectively prepared or State Farm’s reliance on the report was unreasonable. 951 S.W.2d at 448-50. *See Lyons v. Millers Casualty Ins. Co.*, 866 S.W.2d 597, 601 (Tex. 1993) (insurer’s reliance on expert report does not shield it from bad faith liability if there is evidence that the report was not objectively prepared or the insurer’s reliance on the report was unreasonable); *National Union fire Ins. Co. v. Dominguez*, 873 S.W.2d 373, 377 (Tex. 1994) (same). In addition, the Court found as follows:

The Court reversed the malice judgment because there was no evidence of malice as defined in Tex. Civ. Prac. & Rem. Code Ann. § 41.001(6), *revised*, Act of April 11, 1995, 74th Leg., R.S., ch.19, §1, 1995 Tex. Gen. Laws 108, 109. 951 S.W.2d at 450-51.

The Court reversed the judgment under the DTPA that State Farm knowingly engaged in unconscionable conduct because there was no evidence that State Farm took advantage of the Nicolaus to a grossly unfair degree or that the disparity between what the Nicolaus paid for insurance and the amounts they received under the policy was grossly disparate. 951 S.W.2d at 451.

The Court held that the trial court did not err in refusing an instruction about the specific terms of the policy. *Id.* at 451-52.

The Court held that the trial court did not err in refusing to grant a stay or a mistrial based on newly discovered evidence. *Id.* at 452-53.

Finally, the Court remanded to the court of appeals to determine whether the Nicolaus are entitled to recover additional damages based on the jury’s finding that State Farm knowingly engaged in unfair or deceptive acts or practices. *Id.* at 453.

D. “Some Evidence” of a Lack of Objectivity?

In assessing Haag’s alleged lack of objectivity, Justice Spector emphasized that Haag’s engineer testified that Haag Engineering did a substantial amount of work for insurance companies. *Id.* at 448. This engineer testified that 80% to 90% of his work was insurance investigations. *Id.* Haag’s engineer said he knew the insurer would be required to pay if a policyholder’s home was damaged by a leak. *Id.* Spector’s plurality opinion permits the inference that State Farm obtained reports from Haag because of Haag’s general view that plumbing leaks are unlikely to cause foundation damage. *Id.* at 449. Spector’s opinion also relied on the testimony of the Nicolaus’ attorney, who had represented State Farm in the past and testified, without objection, that State Farm’s superintendent hired Haag because he was aware

that Haag, as a general rule, would not agree that a leak caused foundation damage. *Id.* The Nicolaus' attorney also testified that neither of the two engineers who said the leak damaged the slab ever worked on a slab foundation case again. *Id.* Justice Spector acknowledges, however, that “[s]tanding alone, this evidence would not always be evidence of bad faith.” *Id.*

Additionally, Justice Spector emphasized that Haag's investigation was inadequate and this allegedly inadequate investigation is some evidence of pretext. Her plurality opinion notes other “evidence” leading to “some evidence” of unreasonable expert reports and pretext. Spector emphasized that Haag failed to examine the leaking pipe and did not take soil samples or perform moisture content tests. *Id.* at 449. Haag did not do any further testing in response to a report “which had found that water from the leak had spread throughout the soils underlying the Nicolaus' foundation” *Id.* at 797. Spector also noted that the Haag report said soil moisture content should not be considered high and that the Nicolaus' expert found this conclusion to be “ridiculous.” *Id.* State Farm's own expert at trial disagreed with Haag's conclusion about soil moisture. *Id.* at 450.

E. Changes in the Homeowner's Coverage Forms

As noted above, the parties concluded that the Nicolaus' policy covered foundation movement caused by a plumbing leak. Thus, the only question reviewed by the court of appeals was whether there was sufficient evidence establishing that the plumbing leak proximately caused the foundation movement. 869 S.W.2d at 549. The court of appeals held that there was sufficient evidence, *id.*, and the Supreme Court does not address factual sufficiency challenges. *See id.* (citing Tex. Const. art. V, §6; *In re King's Estate*, 244 S.W.2d 660 (Tex. 1951) (per curiam)). The reason State Farm's claims superintendent stipulated that the policy covered plumbing leaks may be found in the policy form under which the case was tried.

The damage to the Nicolaus' home took place between 1984 and 1989. In December 1978, the Texas Board of Insurance had promulgated a new form of the Texas homeowners policy which was used until October 1990. This policy changed the exclusions for wear and tear and cracking of the foundation for Coverage A (Dwelling) claims as set forth in the previous form.

With regard to the pre-December 1978 policy form, Texas appellate courts had consistently held that there was no coverage for a cracked foundation caused by the accidental discharge of water from within a plumbing system because that is a claim under Coverage A to which the referenced exclusions apply. This is the policy construed in *General Ins. Co. of Am. v. Hallmark*, 575 SW.2d 134, 136 (Tex. Civ. App.–Eastland 1978, writ ref'd n.r.e.); *Lambros v. Standard Fire Ins. Co.*, 530 S.W.2d 138, 139 (Tex. Civ. App.–San Antonio 1975, writ ref'd); *Bentley v. National Standard Ins. Co.*, 507 S.W.2d 652, 653 (Tex. Civ. App.–Waco 1974, writ ref'd n.r.e.); *Park v. Hanover Ins. Co.*, 443 S.W.2d 940, 941-42 (Tex. Civ. App.–Amarillo 1969, no writ).

The Homeowner's policy in effect from 1978-1990 added a paragraph – what the Texas Supreme Court has referred to as an “exclusion repeal provision” – to extend coverage for damage caused by the “accidental discharge” of water from a plumbing system. This paragraph

apparently applied to claims under both Coverage A (Dwelling) and Coverage B (Personal Property).

In October 1990, the HOB policy was revised to eliminate the “accidental discharge” language under the exclusions, making those exclusions arguably applicable to claims under Coverage A (Dwelling). The “accidental discharge” language was maintained for claims under Coverage B (Personal Property). The relevant provisions of this policy were not changed in the 1992 and 1996 revisions.

Thus, the current policy arguably reads like the version in effect prior to December, 1978. It was, therefore, arguable that Texas cases construing the pre-1978 versions of the policy were relevant and binding precedent, while any case construing the 1978 version, such as *Nicolau*, was inapposite to cases arising under the post-1990 HOB policy. The Texas Supreme Court rejected this view in *Balandran*.

V. RECENT FOUNDATION DECISIONS

This section of the paper addresses a number of recent Texas appellate decisions that consider the “bona fide” dispute defense, insurer reliance on expert engineering testimony, “access” coverage for plumbing leaks, and limitations issues in foundation cases. These cases follow in the wake of the Texas Supreme Court’s decision in *Balandran v. Safeco Insurance Co.*, 972 S.W.2d 738 (Tex. 1998), which determined that foundation damage caused by plumbing leaks is covered under the standard homeowner’s insurance policy. *Balandran* brought one round of coverage litigation to a close and led to the latest round of litigation involving a broad range of insurance issues, including the inevitable questions of causation that arise in these cases. The cases discussed in this letter are among the first to apply explicitly or by implication the supreme court’s holdings in *Balandran* and to reexamine the “bona fide dispute” defense in the foundation litigation context.

A. *Wallis Places the Ultimate Burden of Proof on Insureds to Allocate Between Covered and Excluded Damages*

An important recent decision of the San Antonio Court of Appeals, *Wallis v. United Services Automobile Association*, 1999 WL 62197 (Tex. App.–San Antonio 1999, no petition), holds that the insured, and not the insurer, has the burden of proving covered damages in foundation and other mixed peril cases. *Wallis* specifically indicates that the insured carries “the burden of segregating the damage attributable solely to the covered event” 1999 WL 62197 at *3. Despite the provisions of Article 21.58(b) of the Insurance Code, *Wallis* emphasizes that “insureds are not entitled to recover under an insurance policy unless they prove their damage is covered by the policy.” *Id.* This recent decision addresses the burden of proof issue more specifically than *Oram v. State Farm Lloyds*, 977 S.W.2d 163 (Tex. App.–Austin 1998, no petition). *Oram* had held that because the insurer failed to plead or request a jury finding on the amount of cosmetic damages or additional living expenses attributable to excluded causes under the policy, the jury’s finding that 60% of damages were caused by a covered peril would apply only to the foundation repair costs. *Id.* at 168. Arguably implicit in *Oram* was the understanding that it is the insurer’s burden to segregate and prove all costs attributable to excluded causes.

Wallis, however, places the burden of segregating damages between covered and uncovered perils squarely on the insured.

In this foundation case, the insureds' claim for damages to their home was denied. The insureds sued their insurer for breach of contract, fraud, negligence, bad faith, and violations of the DTPA and Insurance Code. A jury found the insurer breached its contract but had not committed bad faith or any violation of the DTPA or Insurance Code. 1999 WL 62197 at *1. The jury determined that 35% of the damage was caused by plumbing leaks and 65% was caused by excluded earth movement related to the lot's topography. *Id.*

The trial court entered judgment for the insurer notwithstanding the jury verdict on breach of contract and held the jury's finding on the amount of damage caused by plumbing leaks was not supported by legally sufficient evidence. The San Antonio Court of Appeals affirmed the trial court's entry of a take-nothing judgment in favor of the insurer. *Id.*

1. Factual dispute about whether plumbing leaks caused foundation damage

The homeowners in *Wallis* believed plumbing leaks caused their foundation damage. The insurer's investigation, however, indicated the damage was caused by several excluded perils, including settlement, poor surface drainage, lot topography (the house was built on a slope and was sliding down the lot), and surrounding vegetation. Although the insurer detected leaks in its investigation, it concluded these leaks were "negligible" and had not caused or contributed to complained of damage. *Id.* at *1. The insurer concluded that improper compaction of "fill dirt" upon which the home rested was the primary source of the problem; the house had settled as much as fifteen inches on the low end of the hill where soil was placed to create a plane for the foundation. *Id.* Experts for the homeowners did not challenge the insurer's evidence regarding the excluded perils. These experts did, however, challenge the conclusion drawn regarding the effect of the plumbing leaks and claimed leaks could not be excluded as a contributing cause of damage. *Id.*

Although the engineering testimony varied, the jury heard that the plumbing leaks did contribute to the damage, or that the plumbing leaks could have contributed to the damage, or that the plumbing leaks could not be excluded as a contributing factor to the damage. From this testimony, the jury could have believed that plumbing leaks caused part of the complained-of damage. *Id.* The engineers, however, could not indicate the extent to which plumbing leaks damaged the insureds' home and the court determined that this was fatal to the plaintiffs' claim. *Id.* at *3.

2. Insured has the burden of proof under the "concurrent causes doctrine"

Wallis reasoned that the "doctrine of concurrent causes" places the burden of proof in a mixed peril case on the insureds. 1999 WL 62197, at *2 ("when covered and non-covered perils combine to create a loss, the insured is entitled to recover only that portion of the damage caused

solely by the covered peril(s)"). The court determined that the insured must present some evidence upon which the jury can allocate damages attributable to the covered peril.

The insureds in *Wallis* had argued that article 21.58 of the Insurance Code legislatively overruled any common law duty of insureds to segregate damages between covered and excluded perils. They alleged it was their insurer's burden under article 21.58 to establish what part of the damages was caused by an excluded peril. *Wallis*, 1999 WL 62197, at *1. The court of appeals disagreed and placed the burden of proving the percentage of damages caused by the covered peril on the insureds. The court reasoned that the doctrine of concurrent causation is not an affirmative defense or an avoidance issue on which the insurer has the burden of proof, but rather "is a rule which embodies the basic principle that insureds are entitled to recover only that which is covered under their policy; that for which they paid premiums." 1999 WL 62197, at *2. Because the insureds had not established the percentage of damage caused by a covered peril but only offered evidence from which the jury could have inferred that plumbing leaks had contributed to the loss, there was no evidence supporting the jury's verdict. *Id.* at *3 (noting "[t]he jury heard no testimony regarding how much of the [insureds'] damage was caused by the plumbing leaks. It learned only that plumbing leaks were found").

The court emphasized that "although a plaintiff is not required to establish the amount of his damages with mathematical precision, there must be some reasonable basis upon which the jury's finding rests." *Id.* (citing *Oyster Creek Financial Corp. v. Richwood Investments, II, Inc.*, 957 S.W.2d 640, 649 (Tex. App.—Amarillo 1997, pet. denied)). With neither "mathematical precision, nor a basis from which the jury could reasonably infer that thirty-five percent of the [insureds'] damage was caused by the plumbing leaks," the court affirmed the take-nothing judgment in favor of the insurer.

B. Supporting Authority for *Wallis*

As support for its application of the "concurrent causes" doctrine, *Wallis* cited the following cases: *Lyons v. Millers Casualty Ins. Co. of Texas*, 866 S.W.2d 597, 601 (Tex. 1993); *Employers Casualty Co. v. Block*, 744 S.W.2d 940, 945 (Tex. 1988), *overruled in part on other grounds*, 925 S.W.2d 696 (Tex. 1996); *Travelers Indem. Co. v. McKillip*, 469 S.W.2d 160, 163 (Tex. 1971); *Paulson v. Fire Ins. Exch.*, 393 S.W.2d 316, 319 (Tex. 1965); *Telepak v. United Services Auto. Assoc.*, 887 S.W.2d 506, 507-08 (Tex. App.—San Antonio 1994, writ denied); and *Warrilow v. Norrell*, 791 S.W.2d 515, 527 (Tex.App.—Corpus Christi 1989, writ denied). A number of these cases, however, were decided before article 21.58 of the Insurance Code was enacted and thus could be questioned as viable authority.

1. *McKillip* and *Paulson* Decided Before Article 21.58 Enacted

In *Travelers Indemnity Co. v. McKillip*, 469 S.W.2d 160, 162 (Tex. 1971), the Texas Supreme Court emphasized that the insureds "had the burden to plead their loss was not attributable to the pleaded excluded hazard." The insurer relied on a "snowstorm" exclusion while the insureds claimed damage to their poultry house was caused by wind, a covered peril. The Texas Supreme Court held the insurer was entitled to a special issue on whether damage was caused by a combination of the wind and weight of the snow, and if so, the percentage or the

proportionate part of the damage caused by the snow. *Id.* at 163. The insureds were “obligated to introduce evidence to prove and secure jury findings that the damage was caused by the insured peril from that caused by the snowstorm, an excluded peril.” *Id.* at 162.

Similarly, an earlier decision of the Texas Supreme Court, *Paulson v. Fire Insurance Exchange*, 393 S.W.2d 316 (Tex. 1965) addressed a mixed peril case involving a hurricane. The policy at issue covered loss resulting from hurricanes but not loss resulting from high water. Because there was no evidence from eyewitnesses about the damage done by wind action alone the court of appeals reversed and rendered judgment that plaintiffs take nothing. *Id.* at 319 (emphasizing that the insured must “produce evidence which will afford a reasonable basis for estimating the amount of damage or the proportionate part of damage caused by a risk covered by the insurance policy”). See also *Sherman v. Provident American Ins. Co.*, 421 S.W.2d 652 (Tex. 1967); *Hardware Dealers Mut. Ins. Co. v. Berglund*, 393 S.W.2d 309 (Tex. 1962); *Warrilow v. Norrell*, 791 S.W.2d 515, 527 (Tex.App.–Corpus Christi 1989, writ denied) (“[i]n Texas, if one force is covered and one force is excluded, the insured must show that the property damage was caused solely by the insured force, or he must separate the damage caused by the excluded peril”).

Like *McKillip* and *Paulson*, *Wallis* requires insureds to allocate between covered and uncovered damages, arguably placing the burden on the insured “to negative the exclusions and limitations contained in the policy.” See also *Sherman*, 421 S.W.2d at 654; *Berglund*, 393 S.W.2d at 315. The problem is that *McKillip* and *Paulson* (as well as *Sherman*, and *Berglund*) were decided before article 21.58 of the Insurance Code was adopted. Insureds will argue that article 21.58 shifted the burden of proof -- even in mixed peril cases -- to the insurer, thus changing the law as it existed before 1991.

2. Lyons Requires Insured To Prove Allocation

There are additional Texas cases that support the holding in *Wallis*. For example, in *Lyons v. Millers Casualty Insurance Co. of Texas*, 866 S.W.2d 597 (Tex. 1993), the Texas Supreme Court cited *Paulson* and reiterated that “[w]hen covered and excluded perils combine to cause an injury, the insured must present some evidence affording the jury a reasonable basis on which to allocate the damage.” 866 S.W.2d at 601. See also *Employers Cas. Co. v. Block*, 744 S.W.2d 940 (Tex. 1988) (“An insured cannot recover under an insurance policy unless facts are pleaded and proved showing that damages are covered by his policy”). In *Lyons* the question was whether the homeowner’s damages had been caused by a storm or pre-existing structural problems. The Texas Supreme Court held that “[e]xpert allocation of damages between covered and excluded risks is not . . . necessarily required; circumstantial evidence can suffice.” *Id.* at 601. The testimony of the insured and her neighbors that there was no preexisting damage to the staircase or brick veneer constituted some evidence of the extent of damage attributable solely to the windstorm. *Id.* *Lyons*, however, does not cite or discuss article 21.58 of the Insurance Code.

3. Telepak on the Insured’s Burden of Proof

Another San Antonio decision, *Telepak v. United Services Automobile Association*, 887 S.W.2d 506 (Tex. App.–San Antonio 1994, writ denied), involved the question of whether the

insured or the insurer has the burden of proof on the applicability of an exception to an exclusion in the insurance policy. The San Antonio Court of Appeals held that the insured has the burden of proof on an exception to an exclusion. *Id.* at 507.

The policy in *Telepak* excluded damages resulting from the settling or cracking of a foundation. *Id.* at 506. An exception to this exclusion provided coverage where cracking was caused by water which leaked from an air conditioning or plumbing system. The court concluded it was the insured's burden "to demonstrate the existence of facts supporting the air conditioner exception to the exclusion." *Id.* at 507-08. In other words, "it was incumbent upon the insured to prove his loss was in fact covered by the policy." *Id.* In so holding, the court emphasized that article 21.58(b) is not ambiguous and does not require judicial construction. *Id.* at 507.

Like *Wallis*, *Telepak* may be cited in support of the argument that insureds have the burden of allocating between covered and uncovered damages in a multi-peril case. The policy at issue in *Telepak* provided that damage due to the accidental discharge of water from a plumbing or air conditioning system was an exception to the policy's foundation exclusion. The court determined that the insured had the burden of proof on this exception to the exclusion because it *created* coverage. *Telepak*, 887 S.W.2d at 507. The policy at issue in *Wallis*, however, did not involve a true "exception" to an exclusion but rather what the Texas Supreme Court referred to as an "exclusion repeal provision." *Balandran v. Safeco Insurance Company of America*, 972 S.W.2d 738, 740 (Tex. 1998). *Balandran* determined that this "exclusion repeal provision" was ambiguous and held that the settlement exclusion does not apply to loss caused by the accidental discharge, leakage or overflow of water or steam from within a plumbing, heating or air conditioning system or household appliance. *Balandran* did not resolve the question, however, of who has the burden of allocating damages between covered and excluded damages.

C. Oram Requires Apportionment of Damages

Oram v. State Farm Lloyds, 977 S.W.2d 163 (Tex. App.–Austin 1998, no pet.) is an important decision that allowed recovery of article 21.55's 18% statutory penalty and reasonable attorney's fees for what was, at most, a merely erroneous denial of a claim. *Oram* also implicitly holds that if any part of the insured's foundation claim is covered, the insurer bears the burden of proving the excluded portion of all related expenses; the insurer may not rely on the liability percentages assigned by the jury for the foundation claim to reduce proportionately claims for cosmetic damages or additional living expenses without appropriate pleading and proof.

State Farm denied the homeowners' claim for the costs of repairing damage to the foundation of their home, which they asserted was caused by a plumbing leak. State Farm based its denial on seasonal moisture fluctuations and soil desiccation by surrounding trees. The homeowners then sued State Farm for breach of contract and violations of Insurance Code articles 21.21 and 21.55. *Id.* at 165. The jury found that 60% of the foundation damage was caused by plumbing leaks, but the trial court granted State Farm's motion for judgment and found that the policy did not cover foundation damage caused by plumbing leaks as a matter of law. *Id.*

1. Apportionment of Damages Was Appropriate: 40% of Foundation Repair Costs Were Excluded

The court of appeals reversed the judgment in favor of State Farm based on the Texas Supreme Court's decision in *Balandran v. Safeco Insurance Co.*, 972 S.W.2d 738 (Tex. 1998), and held that the standard homeowner's policy in Texas covers damage to foundations caused by plumbing leaks. *Id.* at 166. Furthermore, the court held that because State Farm failed to plead or request a jury finding on the amount of cosmetic damages or additional living expenses attributable to excluded causes under the policy, the jury's finding that 60% of damages were caused by plumbing leaks would apply only to the foundation repair costs. *Id.* at 168. Implicit in this holding is the understanding that the insurer must segregate and prove all costs attributable to excluded causes.

2. Article 21.55 Penalties Apply Automatically for Wrongful Denial

The court also approved of the Fifth Circuit's analysis in *Higginbotham v. State Farm Mutual Automobile Insurance Co.*, 103 F.3d 456, 461 (5th Cir. 1997), which held that a carrier's wrongful rejection of a claim automatically entitles the insured to recover an 18% statutory penalty and reasonable attorney's fees provided by article 21.55 of the Texas Insurance Code. *Id.* at 167. Based on an award of either contract damages or 21.55 damages, the court also granted the Orams attorney's fees in a dollar amount set by the jury, reasoning that the holding of *Arthur Andersen & Co. v. Perry Equip. Corp.*, 945 S.W.2d 812 (Tex. 1997) (attorney's fees for DTPA claims should not be awarded on a percentage basis but as a dollar amount) applied in this case as well.

3. Reliance on Sharp Precluded Bad Faith

The court of appeals affirmed the trial court's judgment on the article 21.21 violations. Because the Fifth Circuit had previously adopted State Farm's construction of its policy in *Sharp v. State Farm Fire & Casualty Insurance Co.*, 115 F.3d 1258 (5th Cir. 1997) and because the supreme court deemed this construction reasonable in *Balandran*, the court of appeals held as a matter of law that State Farm had a reasonable basis for denying the claim and could not be held liable "merely by erroneously denying the claim." *Id.* at 167. The court also noted that State Farm had a factual basis for denying the claim because it believed the damage was not caused by a plumbing leak; however, the court did not discuss the sufficiency of this basis for avoiding bad faith liability. *Id.* at 167 n.1. Moreover, it is worth noting that the jury failed to find that the Orams had suffered any mental anguish damages. *Id.* at 166.

D. Johns and Conflicts Between Expert Engineers

A recent decision of the Dallas Court of Appeals – *State Farm Lloyds v. Johns*, 1998 WL 548887 (Tex. App.–Dallas Aug. 31, 1998, n.p.h.) (unpublished) – holds that an insurer may not avail itself of the bona fide dispute defense and avoid bad faith liability by merely relying on the opinion of any expert. *Johns* allowed the insured to raise fact issues regarding the credentials and methods of the insurer's expert and required the insurer to both investigate conflicting expert views and to confirm the expert's reputation and expertise. *Johns* also suggests that an insurer's

failure to establish procedures for resolving expert disputes may itself provide a vehicle for an insured's DTPA claim that is less onerous than standard statutory and common law bad faith provisions.

In 1972, Jo Anne Johns bought a house built in 1964. *Id.* at *1. Until 1990, she had observed and repaired minor cracks in the house. In May 1990, she had a claim for water damage from a chimney which leaked in the house. *Id.* at *3. Later that summer, Johns began noticing major cracking of walls and a discernable slope to the floor in parts of the house. *Id.* *4. After a plumber discovered a leak in a drain pipe near the center of the house, Johns made a claim for foundation damage. *Id.* State Farm paid to access the leak, but denied the claim for foundation damage based on its expert's opinion that the damage was not caused by plumbing leaks but rather by natural soil movement. *Id.* at *1. Johns subsequently filed suit against State Farm for breach of contract and various extra-contractual causes of action, including violations of the Insurance Code and DTPA. Based on the jury verdict in favor of Johns, the trial court rendered judgment on the Insurance Code and DTPA violations, including an award of mental anguish and treble damages. *Id.* The court of appeals affirmed.

1. Johns and Conflicts Between Expert Engineers

The court cited *Balandran* to summarily dispose of State Farm's argument that foundation damage caused by plumbing leaks was not a peril covered by the standard homeowner's policy. *Id.* The court then rejected State Farm's contention that reliance on the report of a professional engineer constitutes a reasonable basis for denying a claim as a matter of law. *Id.* at *2. State Farm had hired an expert who concluded that the foundation problems were caused by normal foundation movement. *Id.* at *4. Johns hired her own geotechnical engineer who concluded that plumbing leaks caused swelling of the soil and consequent heaving of the foundation. *Id.* at *5. Because Johns asserted that the report of State Farm's expert "was not objectively prepared" and reliance on the expert report was "unreasonable," the court considered in detail the circumstances surrounding State Farm's claims handling procedure in the case. *Id.* at *3. Evidence creating a fact question on "bad faith" included:

- the claims adjuster's request for authority to engage a specific engineer to inspect the house;
- the fact that this expert had worked for the adjuster on more than ten other claims, none of which the adjuster could remember by name as having been paid;
- the adjuster's testimony that he "felt comfortable with" the engineer's qualifications, though he did not know what they were;
- the expert's steadily increasing dollar-amount of work performed for State Farm;
- the engineer's admitted lack of expertise in geotechnical engineering; and
- State Farm's lack of a procedure for resolving opposing expert opinions.

Although the report of Johns' expert was forwarded to State Farm's expert for review, State Farm's expert merely opined that the report was "not thorough and too general." State Farm's expert doubted that any leaks existed but did no tests and failed to take any soil samples to test the moisture content of the soil under the slab. *Id.* at *5. State Farm did not investigate or attempt to reconcile the apparent contradiction in the experts' opinions through a third expert and

the adjuster admitted he had no expertise to evaluate the dispute. *Id.* Moreover, State Farm’s own records were inconsistent with its expert’s opinion that the problems developed gradually – the adjuster’s report from the chimney claim only a couple of months prior had described the dwelling as being in “good condition” except for the chimney settlement. The adjuster on the foundation claim never discussed this observation with the adjuster for the chimney claim. *Id.* at *4.

In addition to the bad faith bases for affirming the trial court’s award of treble damages under the DTPA and Insurance Code, the court of appeals held that the evidence supported two alternative grounds for the judgment under the DTPA laundry list: (1) failure to adopt and implement reasonable standards or prompt investigation of claims; and (2) refusal to pay claims without conducting a reasonable investigation based upon all available information. *Id.* at *6. This holding is significant because it provided the court with an alternate ground for finding liability on essentially the same conduct as the bad faith claims, but without the “particularized application [of legal sufficiency evidence review] applicable to bad faith claims.” *Id.* Under this holding, State Farm’s lack of a procedure to resolve the dispute between two reputed experts and State Farm’s refusal to follow up on the “opposing opinion by an expert with superior credentials” provided independent bases for State Farm’s liability. *Id.*

2. Evidence Supported Plaintiff’s Mental Anguish Claim

The court also affirmed the jury’s award of mental anguish damages. Johns and other witnesses testified that she was ashamed and embarrassed by the condition of her home and that she experienced nightmares and loss of sleep due to concerns about the house and her future. A friend testified that Johns had cried on “more than a few occasions” and had experienced severe emotional problems. *Id.* at *9. Citing the Texas Supreme Court’s recent decision in *Latham v. Castillo*, 41 Tex. Sup. Ct. J. 994, 996-97 (June 23, 1998), in which the plaintiff testified the defendant’s DTPA violations made him “physically ill” and caused him to vomit, the court held the testimony was sufficient to create a fact issue. Because the case involved “knowing” DTPA violations, the court analogized to cases of intentional or malicious conduct and held that the scrutiny with which the mental anguish damages should be evaluated is lowered when defendant’s culpability “makes it just that the defendant should bear the risk of any overcompensation.” *Id.* The trial court also properly distinguished between mental anguish caused by the denial, which is compensable, and mental anguish caused by the plumbing leaks, which is not. *Id.* Plaintiffs’ lawyers will likely see *Johns* as a road map for recovering mental anguish damages.

E. *Pena* Resolves “Bad Faith” and Limitations Issues in Insured’s Favor

In another recent foundation case, *Pena v. State Farm Lloyds*, 980 S.W.2d 949 (Tex. App.–Corpus Christi 1998, no petition), the homeowners had a leak in a water heater pipe that allowed steam to escape into a basement directly beneath hardwood floors. The hardwood floors buckled and cupped severely. Haag Engineering inspected and found the water heater was the cause of damages. Contractors assessing the damage for the insureds determined that sanding and finishing the floors would not fix the problem. They concluded the house needed subflooring

and a vapor barrier in addition to replacement of the floor. State Farm agreed to pay for sanding and finishing but declined to replace the floorboard.

The insureds later advanced a separate claim for damages caused by movement of a slab foundation under their master bedroom. State Farm's engineer concluded that the leaking water heater in the bathroom could not have caused slab foundation and structural damage. Six leaks in the bathroom, however, were ultimately detected but not until after the initial claim was denied. The insureds subsequently sued and the trial court granted summary judgment based on limitations grounds and a *bona fide* dispute as to coverage. The appellate court reversed and remanded on both issues.

1. Timely Claims for Payments Restarted Limitations

The insureds in *Pena* submitted several claims for foundation damage to State Farm over a number of years. These claims were assigned separate claim numbers. Noting that timely claims for additional payments can begin the statute of limitations running anew, the court of appeals held that the insureds' second and third claims for slab damages related to their initial slab claim and thus tolled limitations. 980 S.W.2d at 954 ("slab foundation problems were essentially on-going" and the initial denial was "effectively reconsidered and withdrawn" thus resetting the starting date for limitations). The court's resolution of this question appears incorrect. An insurer's willingness to review and consider new information from an insured about a potential claim does not effectively "withdraw" an initial denial. The limitations decision in *Pena* seems to be based on a result-oriented legal fiction.

2. *Pena* on the Standard for Bad Faith

Formerly in Texas, to state a cause of action for the breach of the duty of good faith and fair dealing, an insured had to allege there was no reasonable basis for the insurer's denial of a claim, there was a delay in payment by the insurer, or there was a failure on the part of the insurer to investigate. *Arnold v. National County Mut. Fire Ins. Co.*, 725 S.W.2d 165, 167 (Tex. 1987). Recently, in *Universe Life Ins. Co. v. Giles*, the supreme court articulated a new standard, declaring that an insurer acts in bad faith when denying or delaying payment of a claim if it should have been "reasonably clear" that the claim was covered. *Giles*, 950 S.W.2d 48, 54-56 (Tex. 1997). Under the *Giles* standard, the proponent of a bad faith claim has the burden of proving that the insurer knew or should have known it was reasonably clear that the claim was covered. See *State Farm Lloyds v. Nicolau*, 951 S.W.2d 444, 448 (Tex. 1997) (applying new standard on same day of pronouncement). As movant for summary judgment, the insurer may negate an essential element of the appellants' claim by showing that its liability was not reasonably clear, i.e., that there was a reasonable basis for believing a claim was not covered. *Id.* at 446; *Lyons v. Millers Casualty Ins. Co.*, 866 S.W.2d 597, 601 (Tex. 1993); *Aranda v. Insurance Co. of N. Am.*, 748 S.W.2d 210, 213 (Tex. 1988) (carriers retain right to deny invalid or questionable claims without being subject to bad faith liability for erroneous denial of a claim); *Pena*, 980 S.W.2d at 955.

In *Pena*, the court of appeals emphasized that the question of whether an insurer's liability has become reasonably clear presents a fact issue for the jury. *Id.* (citing *Giles*, 950

S.W.2d at 56). The court also determined that whether an insurer acts in bad faith because it denied or delayed payment of a claim after its liability became reasonably clear is also a question for the fact finder. *Id.* Only where there is no conflict in the evidence may a court decide whether there is bad faith as a question of law. *Id.*

3. Poor Investigation and Fact Questions on “Bad Faith”

The court of appeals in *Pena* found a fact question that precluded summary judgment on the issue of “bad faith.” Among other things, the court criticized State Farm for assigning two claim numbers, one for the flooring and one for the slab foundation, while investigating the claims simultaneously as related and resulting from a single cause. Additionally, the court was troubled by the fact that at least seven different claims representatives were assigned to work with the Penas and “only two, perhaps three, of the representatives appear to have meaningfully participated in evaluating and reporting on the status of the Pena’ claims.” 980 S.W.2d at 955. Reviewing the summary judgment record, the court of appeals found that the Penas’ claim had not been “thoroughly investigated” in the following respects:

State Farm’s engineer did not adequately explain why the floor planks needed refinishing only. The engineer said only that the slab “was probably affected by weather patterns and the water demands of a nearby tree.” *Id.* at 956.

Although State Farm had multiple investigations performed, no one ever determined what soils lay beneath the surface of the slab and how these soils were affected by the plumbing leaks. There was no determination of whether the soils were expansive clay, sand, or loosely compacted soil. State Farm’s engineer merely “generalize[d] at length,” but never quite “explain[ed] why the known plumbing leaks could or could not cause or contribute to structural damage” *Id.* at 956.

There were several visible leaks in the plumbing system and a static test was performed which showed a loss of seven inches of water per minute. The cast iron/PVC pipes were in bad condition. *Id.* at 956.

The engineering report was contradictory on the absorption and expansiveness of clay soil and made poor use of the plumbing report. The engineer allegedly made “glaringly inaccurate” statements about the location of the leaks. *Id.*

The court of appeals thus concluded that State Farm’s investigations left unanswered questions about the actual conditions of and under the slab and how the conditions may have been affected by the leaks. Not only did the court emphasize that there were questions concerning the care taken in performance of its investigations, but it also concluded that State Farm’s investigation had continued merely to bolster its denials of the Penas’ claim. As a result, the court reversed the summary judgment rendered in favor of State Farm on bad faith and remanded for further proceedings.

F. *McGuinness* and Limitations in Foundation Cases

Unlike the *Pena* case, *McGuinness v. State Farm Fire & Casualty Company*, 1998 WL 767728 (Tex. App.–Houston [1st Dist.] Nov. 5, 1998, pet. filed) (unpublished) holds that an aggrieved insured must diligently and timely protest a insurer’s claim decision and be willing to litigate to prevent limitations from running. The McGuinnesses purchased a house in 1987 and insured it with State Farm. *Id.* at *1. At the time of purchase, the McGuinnesses knew that the floor in the master bedroom dipped and that the house had some minor foundation problems. *Id.* In 1989, the McGuinnesses had foundation and plumbing work done to correct the problem. *Id.* Their foundation repair company indicated that the floor problems were caused by soil heaving. An engineering company, also hired by the McGuinnesses, stated that the heaving could have been caused by high soil moisture from a plumbing leak. *Id.* at *4. The McGuinnesses’ plumber found a complete separation of a sewage pipe under the master bedroom; even after the repair, the pipe continued to leak at a rate of 1 ½ gallons per day. *Id.*

After the McGuinnesses filed a claim, State Farm engaged Haag Engineering to evaluate the problem. Haag determined that soil settlement had caused the foundation movement and that plumbing leaks below the slab “did not contribute significantly.” *Id.* at *1. State Farm denied coverage based on this assessment. The McGuinnesses apparently accepted this assessment and denial until 1993, when the bedroom floor began doming. *Id.* The McGuinnesses then asked State Farm to reevaluate its decision on the 1989 claim. *Id.* After removing part of the slab, the McGuinnesses discovered massive tree roots, which their consultants concluded were attracted by the plumbing leaks. *Id.* Haag attributed the attraction to the inherent moisture of the soil; a tree expert hired by State Farm stated that the roots were under or near the slab when it was poured. *Id.*

State Farm denied the “reevaluated” claim in December 1994, which led the McGuinnesses to file suit for breach of contract, common law fraud, negligence, bad faith, and violations of the Texas Insurance Code and DTPA in 1995. *Id.* The trial court granted summary judgment in favor of State Farm. *Id.*

The court of appeals affirmed summary judgment on the basis of limitations. As repeatedly noted by the court, all of the parties considered the additional movement in 1993 to be a continuation and reevaluation of the 1989 claim, not an independent claim. *Id.* at *5. Consequently, all of the McGuinnesses’ causes of action were subject to a two or four-year statute of limitations, both of which had expired by the time suit was filed in 1995. *Id.* at *2-3. With regard to the extra-contractual claims, the McGuinnesses argued that the discovery rule applied and did not start to run until the tree roots were discovered in 1993. Holding that the injury-producing event was the denial of coverage, which State Farm had expressly communicated in 1989, the court also noted that the differing opinions of State Farm’s and the McGuinnesses’ experts provided sufficient factual incentive for a reasonable person to inquire further after the 1989 denial. *Id.* at *3, 5.

The McGuinnesses also argued that State Farm fraudulently concealed their claims in an attempt to toll limitations. To establish fraudulent concealment, a form of equitable estoppel, the plaintiff must prove the defendant’s actual knowledge of a wrong, a duty to disclose that wrong, and a fixed purpose to conceal it. *Id.* at *3 (citations omitted). The estoppel effect ceases when

the facts or circumstances would cause a reasonably prudent person to make inquiry that would lead to discovery of the concealed cause of action. *Id.*

In support of their argument, the McGuinnesses offered a handwritten note by a Haag employee that completely contradicted the conclusions of Haag's subsequent report. This note stated "gave verbal: water leak has caused increase in settlement, he asked for written report." *Id.* The court refused to consider the note, however, because it was not part of the summary judgment record. *Id.* In the absence of any supporting evidence, the court refused to consider an argument that "showed Haag was in corrupt collusion with State Farm," or that State Farm knew of any deliberate falsity by Haag. *Id.* at *4. Finally, the court reiterated that the McGuinnesses had access to facts sufficient to require further inquiry. *Id.* at *5.

G. *McGuinness* and Limitations in Foundation Cases; *Keenan*, Contractor Negligence, and Recovery for Access Costs

In *Keenan v. Wausau Lloyds Ins. Co.*, 1998 WL 652332 (Tex. App.--San Antonio 1998, no petition), the homeowners sustained loss to carpet, vinyl flooring, an electrical outlet, and art supplies stored in a closet when a toilet overflowed. *Id.* at *1. Based on its engineering expert's report, Wausau paid the claim for property damage, but denied the homeowners' request for payment of costs to access the plumbing lines because its engineer had determined the overflow was due to a construction defect of pipes. The pipes were allegedly sloped inadequately for proper drainage. In subsequent litigation the Keenans asserted claims for breach of contract and extra-contractual damages. On cross-motions for summary judgment, the trial court ruled in favor of Wausau. *Id.*

On appeal, the court reversed the judgment of the trial court and remanded for further proceedings. Wausau moved for summary judgment asserting two basic grounds (1) the access provision of the policy required physical loss to the plumbing line itself; and (2) the access provision applied only to the loss of personal property under Coverage B of the policy. In addition to noting that reliance on *Sharp v. State Farm Fire & Casualty Insurance Co.*, 115 F.3d 1258 (5th Cir. 1997) was misplaced because personal property (art supplies) had been damaged by the accidental discharge, the court opined that *Sharp's* precedential value was limited by the Texas Supreme Court's decision in *Balandran v. Safeco Insurance Co.*, 972 S.W.2d 738 (Tex. 1998). Because dwelling Coverage A applies broadly to "all risks of physical loss to the property," while Coverage B applies only to risks specified in the policy, the court held that Coverage A includes those perils and conditions identified in Coverage B unless the language is qualified to clearly limit its application to personal property. *Id.* at *5. Despite the access provision's placement in Coverage B, the loss to which it applied was unqualified, thereby making it applicable to both dwelling and personal property losses. *Id.*

The court also rejected Wausau's contention that the policy required a physical loss to the plumbing system itself before the cost of access is covered. Holding that the policy plainly covered the cost of access "without regard to the nature of the problem" if the damage occurred from one of the listed sources, the court distinguished claims based solely on the cost of repairing faulty workmanship from claims involving an accident or loss caused by the faulty workmanship. *Id.* at *3. Moreover, the court found unpersuasive Wausau's argument that paying

for access on a construction defect transforms a homeowner's policy into a partial warranty policy for the contractor; the court observed that physical loss resulting from negligence in choosing substandard building materials is indistinguishable for insurance purposes from the loss caused by engineering defects. *Id.* at *4.

H. *Ferris* Also Implicitly Recognizes Coverage for Access Costs

In *Ferris v. State Farm Lloyds*, 1998 WL 747082 (Tex. App.–San Antonio 1998, no petition) State Farm denied the homeowners' claim for damage to their home caused by foundation movement that resulted from a plumbing leak. *Id.* The trial court granted State Farm summary judgment on the contractual coverage and access claims and on all extra-contractual causes of action. *Id.* Based on the supreme court's decision in *Balandran*, the San Antonio Court of Appeals reversed the trial court's judgment and remanded the case for consideration of all the homeowners' causes of action. *Id.*

In its brief opinion, the appellate court essentially resolved all questions on procedural bases. State Farm conceded the basic coverage issue under *Balandran*, but maintained that the summary judgment regarding plumbing access and extra-contractual causes of action could be affirmed. *Id.* at *2. However, while State Farm had undeniably paid \$1,664.25 to access the plumbing leaks, the court remanded the access question because there was no stipulation or evidence in the record that this was the total amount owing for all access costs. *Id.* The court thus implicitly recognized the existence of coverage under the standard homeowner's policy for "access" claims. The court also rejected as premature State Farm's argument that *Balandran* allowed an affirmance of judgment on the extra-contractual causes of action because State Farm had not (and could not have) presented this ground to the trial court. *Id.*

VI. THE MEANING OF THE "EARTH MOVEMENT" EXCLUSION: THE NEXT ROUND OF LITIGATION

Although *Balandran* has resolved the question of how Exclusion 1(h) – the "settlement" exclusion – applies in cases involving residential foundation damage caused by plumbing leaks, the Texas Supreme Court has never addressed whether and how Exclusion 1(k), – the "earth movement" exclusion – applies in a similar situation. Exclusion 1(k) precludes coverage for "loss caused by earthquake, landslide or earth movement." There are very few Texas appellate decisions addressing the earth movement exclusion. As a result, it is likely we will see another round of foundation coverage litigation involving the "earth movement" exclusion, plumbing leaks, and the expansive actions of clay soils in Texas.

As discussed above, the principle of *ejusdem generis* provides that general words in a contract are construed to mean only the class or category framed by preceding specific words. This interpretive principle would appear to restrict the phrase "earth movement" in Exclusion 1(k) to natural and relatively catastrophic events. One Texas case, *Jones v. St. Paul Insurance Co.*, 725 S.W.2d 291, 294-95 (Tex. App.–Corpus Christi 1986, no writ), has come to precisely this conclusion.

A. Texas Cases on "Earth Movement"

1. *Jones v. St. Paul Insurance*

In *Jones v. St. Paul Insurance Co.*, the insured sued St. Paul to recover under a property insurance policy after the roof of his commercial building collapsed. The issue before the court of appeals was whether the earth movement exclusion in the insurance policy was properly submitted to the jury. The court held that the action of expansive clay soil, which led to the movement of a wall and the collapse of a roof, was not earth movement within the meaning of the policy. The exclusion contemplated abnormally large movements (like earthquakes and landslides). The court thus rejected the insurer's argument that the exclusion "embrace[d] in its scope expansion and contraction due to soil moisture variations." *Id.* at 292. The insurer's argument that, under the plain meaning of the policy, "any movement of the earth excludes coverage," would have rendered the "settlement" exclusion meaningless. The trial court thus erred in submitting an "earth movement" question to the jury and in entering a take-nothing judgment against the insured.

2. Unpublished decision *Reyes v. Fire Insurance Exchange*

In *Reyes v. Fire Insurance Exchange*, 1996 WL 603844 (Tex. App. - San Antonio 1996, writ dismissed w.o.j.) (unpublished opinion), the insureds claimed damages to their windows, shower, driveway, patio and ceiling as a result of vibrations from heavy construction equipment used in resurfacing the street next to their property. The insurer denied coverage based upon Exclusion 1(h), the "settlement" exclusion, and Exclusion 1(k), the "earth movement" exclusion. The trial court granted summary judgment in favor of the insurer and the insureds appealed.

The court of appeals affirmed summary judgment because the insureds had not raised a point of error or briefed the question of whether the "earth movement" exclusion applied. *Reyes* is properly considered an appellate waiver case since the insureds simply did not brief the question of whether vibration from a construction project was "earth movement" within the meaning of Exclusion 1(k). There are, however, a number of cases from other jurisdictions splitting on the question of whether the "earth movement" exclusion applies only to abnormally large earth movement during natural catastrophes like volcanoes, earthquakes, landslides, mudslides, etc.

B. Cases from other Jurisdictions on "Earth Movement"

Cases from other jurisdictions finding that the "earth movement" exclusion applies only to abnormally large earth movement and natural catastrophes include:

Clyce v. St. Paul Fire and Marine Insurance Co., 850 F.2d 1398, 1401 (11th Cir. 1987) (trial court did not err in instructing jury that "earth pressure" and "earth movement," a peril excluded by the policy, were different causes of loss, permitting the jury to award \$9500 for collapse of the insured's retaining wall caused by "earth pressure" from weight of soil as described by an engineer).

Cox v. State Farm Fire and Casualty Co., 459 S.E.2d 446, 447 (Ga. Ct. App. 1995) (policy did not exclude coverage for damage to insureds' dwelling caused

by vibrations resulting from explosions in the vicinity of insureds' property; policy covered damage caused by explosions; earth movement exclusion was limited to natural causes).

Kyle v. United Services Automobile Association, 30 Cal. Rptr.2d 163, 174-75 (Cal. Ct. App. 1994) (insureds were entitled to the cost of construction of a retaining wall around the unstable portion of their home to stabilize it and prevent further damage caused by slippage down a hill; "earth movement" exclusion did not apply).

Opsal v. United Services Automobile Association, 10 Cal. Rptr.2d 352, 355 (Cal. Ct. App. 1991) (policy covered cost of repairing cracked slab in insured's home; earth movement exclusion applied only to naturally occurring earth movement).

Davis v. United Services Automobile Ass'n, 273 Cal. Rptr.2d 224, 228-29 (Cal. Ct. App. 1990) (insureds could recover for loss caused by earth movement where contractor failed to reinforce foundation slab and prepare subgrade soils).

Villella v. Public Employees Mutual Insurance Co., 725 P.2d 957, 959 (Wa. Ct. App. 1986) ("earth movement" exclusion would not exclude coverage where damage was caused by leak from a poorly constructed drainage system).

Henning Nelson Construction Co. v. Fireman's Fund American Life Insurance Co., 361 N.W.2d 446, 449 (Minn. Ct. App. 1985) (policy exclusions for earth movement, water and design defect did not apply to exclude coverage for the collapse of a wall where cause of collapse was a covered risk; exclusion for earth movement applied only to natural disasters in the nature of those listed in the same provision, earthquake, volcano, and landslide).

Bly v. Auto Owners Insurance Co., 437 S.2d 495, 496-97 (Ala. 1983) (policy covered damages to insureds' home caused by vibrations from heavily loaded logging trucks operating on nearby roads; noting decisions applying *ejusdem generis* principles to find that "earth movement" applies to "natural phenomena" only).

Mattis v. State Farm Fire and Casualty Co., 454 N.E.2d 1156, 1160 (Ill. Ct. App. 1983) ("earth movement" excludes earthquakes, and landslides and similar events, not the consolidation and settlement of backfill against a basement wall).

Steele v. Statesman Insurance Co., 607 A.2d 742, 743 (Pa. 1992) (earth movement exclusion barred coverage for damage caused only by natural events, not damages caused by the insured's neighbor who overbuilt, overloaded, and overburdened the hillside properties shared).

Cases from other jurisdictions finding that the "earth movement" exclusion broadly precludes coverage for more than just natural catastrophes include:

West v. Harris, 573 F.2d 873, 877 (5th Cir. 1978) (addressing Louisiana law and finding the “earth movement” exclusion precluded coverage for damage to insured’s residence caused by a sinking slab caused by subsidence after a flood; the exclusion provided that the insured would not be liable for loss caused by “erosion, earthquake, landslide or any other earth movement, except such mudslides as are covered under the peril of flood”; the court found this “flood” policy did not cover loss caused by earth movement in the form of settlement).

Moyer v. Director of Fed. Em. Mgmt Agency, 721 F. Supp. 235, 238 (D. Az. 1989) (damage to insured’s residence caused by land subsidence or settlement of concrete slab at its base after flooding was not covered by standard flood policy; earthquake exclusion applied).

Kula v. State Farm Fire and Casualty Co., 628 N.Y.S.2d 988, 989 (N.Y. App. Div. 1995) (policy defined “earth movement” to mean the “sinking, rising, shifting, expanding or contracting of earth, all whether combined with water” and included “earthquake, landslide, mudflow, sinkhole, subsidence, and erosion; policy unambiguously excluded coverage for damage to insured’s dwelling caused by a rupture of a water pipe carrying well water to home under its foundation; “earth movement” exclusion was not limited to loss from natural causes and precluded coverage).

Alleman v. American Bankers Insurance Co., 636 So.2d 294, 298 (La. Ct. App. 1994) (flood policy excluded coverage for settlement or other soil movement, precluding coverage for damage to slab on which the insured’s home sat).

Millar v. State Farm Fire and Casualty Co., 804 P.2d 822, 826 (Az. Ct. App. 1990) (“earth movement” exclusion unambiguously excluded coverage for damage to home when soil beneath it collapsed due to water which had escaped from automatic sprinkler system).

Brodkin v. State Farm Fire and Casualty Co., 265 Cal. Rptr.2d 710, 712 (Cal. Ct. App. 1989) (policy excluded coverage for cracks in floor and foundation of insured’s home whether caused by earth movement as insurer contended, or by the presence of corrosives in the soil or negligent construction as alleged by the insureds).

State Farm Fire and Casualty Co. v. Martin, 668 F. Supp. 1379, 1382-83 (C.D. Cal. 1987) (policy unambiguously excluded coverage for damage to insureds’ home primarily caused by excluded perils of earth movement, settling and deterioration).

Andreasen v. City of Houma, 517 So.2d 321, 324 (La. Ct. App. 1987) (policy did not cover damage to insured’s home caused by soil subsidence; earth movement exclusion precluded coverage).

Nida v. State Farm Fire and Casualty Co., 454 So.2d 328, 330 (La. Ct. App. 1984) (policy did not cover damage to insured's home consisting of cracked foundation and interior and exterior walls sticking doors and buckling wallpaper caused by a condition of clay soil beneath the foundation which caused the foundation to move up and down during wet and dry weather; *ejusdem generis* had no application because the exclusion precluded coverage for "earth movement" only without mentioning any words of specific meaning like earthquake or landslide, which would have limited the words "earth movement" to a particular kind or class of incident).

State Farm Insurance Co. v. Gilbert, 621 S.W.2d 880 (Ark. Ct. App. 1981) (where insured's masonry retaining wall collapsed, throwing dirt, concrete and brick into his yard and swimming pool, trial court erred in directing verdict for insured on grounds that the "earth movement" exclusion was ambiguous).

The split in authority from non-Texas jurisdictions on the meaning of the "earth movement" exclusion virtually guarantees coverage litigation in Texas on this question in the future.

VII. RECENT ARSON DECISIONS OF THE TEXAS COURTS

A. Arson and the Texas Homeowner's Policy

1. Arson as a Common-Law Defense

"Arson" is a common-law defense to a civil suit for insurance proceeds. *State Farm Fire and Cas. Ins. Co. v. Vandiver*, 970 S.W.2d 731, 736 (Tex. App.–Waco 1998, no petition); *Blankenship v. St. Paul Guardian Ins. Co.*, 911 S.W.2d 95 (Tex. App.–Tyler 1995, no writ). To establish arson as a defense to a civil suit for insurance proceeds, the insurance company must show by a preponderance of the evidence that the insured set the fire or caused the fire to be set. *St. Paul Guardian Ins. Co. v. Luker*, 801 S.W.2d 614 (Tex. App.–Texarkana 1999, no writ); *Blankenship*, 911 S.W.2d at 96; *State Farm Lloyds, Inc. v. Polasek*, 847 S.W.2d 279 (Tex. App.–San Antonio 1992, writ den'd).

Texas courts have recognized that arson is "ordinarily conceived in secrecy and executed in such a manner as to avoid detection and exposure . . ." *Vandiver*, 970 S.W.2d at 736. As a result, proof of arson "must, in the very nature of things, be made by circumstances, and every circumstance which tends to cast light upon the incident is legitimate and proper." *Id.*

In order to establish the affirmative defense, the insurer must offer evidence:

- the fire had an incendiary origin;
- the insured had a motive to set the fire or cause it to be set; and
- the insured had an opportunity to set the fire or other circumstances linking the insured to the fire.

See Id.; *Polasek*, 847 S.W.2d at 282; *Johnson v. Garza*, 884 S.W.2d 831, 834- 35 (Tex.App.–Austin 1994, writ denied).

Unlike homeowners policies in other states, the Texas Standard Homeowner’s Policy--Form B does not include a clause barring or limiting recovery for property losses intentionally caused by an insured. Section II of the policy excludes personal liability coverage for “bodily injury or property damages which is caused intentionally by or at the direction of the insured,” but no similar exclusion applies to the insured’s own property losses. *Texas Farmers Insurance Co. v. Murphy*, 996 S.W.2d 873, 879 (Tex. 1999).

2. The Concealment Clause in the Arson Context

The Texas Homeowner’s Policy, however, does include a condition to bar coverage for all insureds if any one of them commits a fraud or intentionally conceals or misrepresents a material fact:

Concealment or Fraud. This policy is void as to you and any other insured, if you or any other insured under this policy has intentionally concealed or misrepresented any material fact or circumstance, made false statements or committed fraud relating to this insurance, whether before or after a loss.

In a recent arson case, *Texas Farmers Insurance Co. v. Murphy*, 996 S.W.2d 873 (Tex. 1999), Farmers Insurance claimed insured Robert Murphy triggered the concealment clause by making a claim on the policy after intentionally burning his house down. Farmers further asserted that this condition unambiguously barred recovery not only by Robert, but also for his ex-wife Daisy.

Although Farmers plead the concealment-clause defense, it did not obtain any jury findings on it. Farmers made no mention of this defense before the trial court or the court of appeals. In sum, Farmers’ challenge to Daisy’s right of recovery was predicated entirely on public policy grounds alone. 996 S.W.2d at 880. Although Farmers attempted to revive its concealment-clause defense in its brief and oral arguments, the Texas Supreme Court found that Farmers had abandoned and waived any defense to liability under the concealment clause. *Id.*

Murphy holds that, in the absence of a valid contractual defense properly pled and preserved by the insurance carrier, no public policy prevents an innocent spouse from recovering his or her interest in insured community property destroyed by the other spouse. 996 S.W.2d at 875. The court also held that partition of the community interest in insurance proceeds or divorce is no prerequisite to recovery of the policy benefits. *Id.* at 881.

Although the entire *Murphy* court agreed that the fraud defense would defeat even an innocent spouse’s recovery, none of the opinions considered the anti-technicality statute, Insurance Code article 21.19, which requires that “misrepresentations or false statements [made] in proofs of loss” be material and mislead the carrier and cause it to waive or lose some valid defense to the policy before such misrepresentations may be relied on to void the carrier’s liability under the policy. *Murphy* thus allows insurers to argue that the arson itself constitutes a

“fraud” for purposes of the policy defense that is not subject to the anti-technicality statute’s limitations on “false statements” or “misrepresentations.”

B. *Simmons* and “Bad Faith” Liability for Deficient Investigations

In July of 1997, the Texas Supreme Court revisited the question of how to define common law “bad faith” in Texas. Revising the negative phrasing of the *Arnold/Aranda* “no reasonable basis standard,” the decisions in *Giles*, *Nicolau*, and *U.S. Fire v. Williams* hold that “an insurer will be liable [for common law bad faith] if the insurer knew or should have known that it was reasonably clear that the claim was covered.” Although *Giles*, *Nicolau*, and *Williams* provided a significant modification of the standard for common law bad faith, these decisions did not necessarily jettison the “bona fide” dispute standard previously articulated in *Lyons*, *Dominguez*, and *Moriel*.

In an important bad faith “failure to investigate” case -- *State Farm Fire & Casualty Co. v. Simmons*, 963 S.W.2d 42 (Tex. 1998) -- the Texas Supreme Court cited but really did not apply the “bona fide dispute” defense as previously articulated. *Simmons* arguably permits recovery in a bad faith case for merely “deficient” investigations, thereby depriving insurers of the promise of *Aranda*, “the right to be wrong.” The 6-3 majority opinion in *Simmons*, authored by Justice Spector, deferred to a Montgomery County jury and found that State Farm improperly denied the Simmonses’ fire claim by “targeting” the insureds while failing to investigate neighbors who already had burglarized and vandalized the Simmonses’ home.

Much like the Court’s *Nicolau* decision, *Simmons* reflects an internecine struggle between competing views of insurance companies. Justice Spector’s viewpoint -- which mirrors John Grisham’s *The Rainmaker* -- imputes evil motives to insurance companies in nearly all situations. Justice Hecht, on the other hand, takes a more benign view of insurers, and has consistently pressed for resolution of “bad faith” issues as a matter of law. It took a divided Court more than four years to resolve *Simmons*, but ultimately Justice Spector’s viewpoint carried the day.

After a fact-specific recitation of the record, the *Simmons* majority concluded that State Farm breached its duty of good faith and fair dealing by conducting “a biased investigation intended to construct a pretextual basis for denial.” 963 S.W.2d at 44. While acknowledging (1) that “evidence establishing only a bona fide coverage dispute does not demonstrate bad faith” and (2) that “[a]n insurance company’s obligation to investigate is obviously not unlimited,” the Court still concluded that State Farm did not make a good-faith effort to investigate objectively, but instead engaged in an “outcome-oriented investigation designed to place the Simmonses at the center of an ‘arson triangle.’” *Id.* at 45.

C. Deficient, Outcome-Oriented Investigation in *Simmons*?

In affirming “bad faith” for an alleged failure to investigate, the *Simmons* majority emphasized that the testimony of State Farm’s own experts, as well as its own internal documents, established the deficiencies of the company’s review of the Simmonses’ claim. The Court criticized State Farm for immediately deeming the fire loss “suspicious” just because the

Simmonses had filed a previous theft claim that was paid. Additionally, State Farm's adjuster had testified that revenge and spite were common motivations for arson and the Simmonses had identified five people who may have had grudges against them. State Farm, however, never attempted to locate these individuals and the combined fire report listed locating these individuals as an unfinished item of investigation. *Id.* at 45.

The Court also noted that State Farm's investigation did not objectively address the common indicators of fraud by arson, which include:

1. a recently purchased policy or a recently increased policy;
2. a policy that significantly exceeds the insured property's value;
 - efforts by the insured to sell the property or other concrete indications that the insured intended to move;
 - prior fire losses;
 - a strong alibi for the insured;
 - unusual money problems, such as high medical bills or legal fees;
 - the removal of furniture or personal items before the fire; or
 - a "huge [financial] burden" resulting from the strain of meeting everyday expenses. 963 S.W.2d at 46.

None of the first six criteria were met for the Simmonses' claim and State Farm's information on the last two criteria was erroneous and thus did not provide a "reasonable basis" for denial. *Id.* ("If the Simmonses had actually burned their house, they would have been left with no home and a deficiency owed to their mortgage lender.") To the extent there was a conflict on the amount of the Simmonses' mortgage obligation, "the jury could have inferred that a reasonable insurer would have approached its insureds to resolve the apparently conflicting information and would have eventually concluded that the insureds lacked a sufficient motive to commit arson." *Id.* at 47.

In dissent, Justice Hecht emphasized that coverage for the Simmonses' fire loss was the subject of a bona fide dispute. In large part, the undisputed evidence regarding two prongs of the arson triangle -- opportunity and motive -- came from the Simmonses themselves. Moreover, no party contested that the fire was intentionally set, the third prong of the arson triangle. Justice Hecht lamented that under *Simmons* "proof that an insurer's investigation was deficient in some respect is enough for bad faith liability." *Id.* at 49. Hecht would have required proof "that the deficient investigation led the insurer to deny the claim when liability was reasonably clear" -- not just proof of a merely deficient investigation. *Id.* Although Justice Hecht does not believe the majority intended to impose bad faith liability on every insurer whose investigation is "deficient" in some respect, *Simmons* will likely result in many bad faith cases going to a jury where previously summary judgment would have been appropriate. At the very least, *Simmons* creates confusion and reflects a willingness to address "bad faith" on a case-by-case basis.

Although the Texas Supreme Court found "bad faith" liability for State Farm's alleged failure to investigate (and thus a DTPA violation as well), the court reversed the jury's award of two million dollars in punitive damages. The Court reiterated that "[o]nly when accompanied by malicious, intentional, fraudulent or grossly negligent conduct does bad faith justify punitive

damages.” 963 S.W.2d at 47 (citing *Moriel*, 879, S.W.2d at 18). The Simmonses were required to introduce evidence showing that State Farm “was actually aware that its action would probably result in extraordinary harm not ordinarily associated with breach of contract or bad faith denial of a claim -- such as death, grievous physical injury, or financial ruin.” *Id.* (citing *Moriel*, 879 S.W.2d at 24). Reviewing the record, the Court found the evidence legally insufficient to support an award of punitive damages. *Id.* This reaffirmation of *Moriel* on punitive damages in “bad faith” cases is useful in a case that otherwise appears to depart from the *Lyons*, *Dominguez*, and *Moriel* trilogy.

D. *Evry v. USAA*: a Recent “Bad Faith” Arson/Insurance Case

Evry v. United Serv. Auto. Ass’n, 979 S.W.2d 818 (Tex. App.–Eastland 1998, pet. denied) involved an insurer’s denial of coverage in a arson case. The homeowners sued for \$677,000 dwelling and \$700,000 contents coverage. They also sought damages for bad faith, DTPA, and Insurance Code violations.

The trial court directed a verdict on the issue of common law and statutory “bad faith.” *Id.* at 818. The appellate court affirmed and held the homeowners had failed to prove that the insurer’s liability had become “reasonably clear.” *Id.* at 822 (citing *Simmons*, *Giles*, *Dominguez*, and *Moriel*). On the question of arson, the jury determined that either the homeowners or “someone acting on their behalf or with their knowledge” had intentionally set fire to the house. *Id.* at 819-820.

The appellate court affirmed the directed verdict on “bad faith” and the jury’s finding of “arson,” emphasizing the circumstantial evidence of arson, including:

- the presence of accelerant and distinctive burn patterns at the house;
- two fires at the house, the second starting the day after fire department personnel extinguished the initial fire;
- the house was locked at the time of the fire, only three people had keys, and the burglar alarm never went off before the fire;
- furniture and clothing were removed from the house before the first fire was set;
- the homeowners had increased their insurance coverage shortly before the fire; and
- the homeowners were having financial difficulties.

Id. at 821-822.

Texas Homeowner’s Policy (Before December 1978)
Perils Insured Against

Property as described and limited under Coverage A is insured against: ALL RISKS OF PHYSICAL LOSS except as otherwise excluded.

Unscheduled Personal Property as described and limited under Coverage B is insured against loss by:

* * *

Accidental discharge, leakage, or overflow of water or steam used within a plumbing system ...;

Exclusions (Applicable to Property Insured under Coverages A and B and Perils Insured Against)–This insurance does not cover

* * *

g. Loss caused by ... earth movement;

* * *

i. Loss caused by ... wear and tear, deterioration; ...

* * *

k. Loss under Coverage A caused by settling, cracking, bulging, shrinkage, or expansion of foundations, walls, floors, ceilings, roof structures, walks, drives, curbs, fences, retaining walls or swimming pools.

... Exclusions i, j and k shall not apply to ensuing loss, caused by ... water damage ... provided such losses would otherwise be covered until this policy.

Texas Homeowner's Policy (December 1978 -1990)

Property as described and limited under Coverage A is insured against: ALL RISKS OF PHYSICAL LOSS except as otherwise excluded.

Unscheduled Personal Property as described and limited under Coverage B is insured against loss by:

* * *

Accidental discharge, leakage, or overflow of water or steam used within a plumbing . . . system . . . ;

Exclusions (Applicable to Property Insured under Coverage A and B and Perils Insured Against)–This insurance does not cover:

* * *

g. Loss caused by . . . earth movement;

* * *

i. Loss caused by . . . wear and tear, deterioration; . . .

* * *

k. Loss under Coverage A caused by settling, cracking, bulging, shrinkage, or expansion of foundations, walls, floors, ceilings, roof structures, walks, drives, curbs, fences, retaining walls or swimming pools.

* * *

The foregoing exclusions ... i, j and k, shall not apply to Accidental discharge, leakage or overflow of water or steam from within a plumbing. . . system. . . .

Exclusions i . . . and k shall not apply to ensuing loss, caused by . . . water damage . . . provided such losses would otherwise be covered under this policy.

SECTION I - PERILS INSURED AGAINST

COVERAGE A

(DWELLING)

We insure against all risks of physical loss to the property described in Section I Property Coverage, Coverage A (Dwelling) unless the loss is excluded in Section I Exclusion.

SECTION I EXCLUSIONS

h. We do not cover loss under Coverage A (Dwelling) caused by settling, cracking, bulging, shrinkage, or expansion of foundations, walls, floors, ceilings, roof structures, walks, drives, curbs, fences, retaining walls or swimming pools.

We do cover ensuing loss caused by collapse of building or any part of the building, water damage or breakage of glass which is part of the building if the loss would otherwise be covered under this policy.

COVERAGE B

(PERSONAL PROPERTY)

We insure against physical loss to the property described in Section I Property Coverage, Coverage B (Personal Property) caused by a peril listed below, unless the loss is excluded in Section I Exclusions.

9. Accidental Discharge, leakage or Overflow of Water or Steam form within a plumbing, heating or air conditioning system or household appliance.

A loss resulting from this peril includes the cost of tearing out and replacing any part of the building necessary to repair or replace the system or appliance. But this does not include loss to the system or appliance from which the water or steam escaped.

Exclusions 1.a. through 1.h. under Section Exclusions do not apply to loss caused by this peril.