

**FIFTH CIRCUIT SORTS OUT ALLOCATION OF DEFENSE COSTS  
IN COMPLICATED CONSTRUCTION DEFECT COVERAGE SITUATION  
INVOLVING GL, E&O, A.I. AND EXCESS COVERAGES  
AND A BANKRUPT INSURED**

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Those of us who litigate and analyze construction defect coverage situations are used to encountering complex situations resulting from various lines and levels of coverage. Yesterday, the Fifth Circuit in *Continental Cas. Co. v. North American Capacity Ins. Co.* confronted the responsibility of paying approximately \$5.7 million in costs incurred defending a general contractor between four insurers covering different lines and levels of coverage. Bottom line, the court found that three primary insurers, the general contractor's CGL and E&O carriers and a subcontractor's CGL carrier (insuring the general contractor as an additional insured) were required to equally split the defense costs. This allowed the general contractor's excess insurer to recover its \$3 million contribution toward defense costs and provided a partial recovery to the general contractor's primary CGL insurer's \$2.7 million defense costs contribution.

Valero Refining contracted with Encompass Power to construct a co-generation facility at a California oil refinery. Encompass subcontracted with ECCO Engineering for electrical work. Encompass possessed a \$1 million primary CGL policy with Continental Casualty; a \$20 million E&O policy (over a \$250,000 SIR) with Columbia Casualty; a \$25 million umbrella policy with National Union and was an additional named insured under ECCO's \$1 million primary CGL policy with North American. The Valero refinery was significantly damaged by power outages and a fire. That led to Valero suing Encompass for \$40 million alleging that Encompass and its subcontractors were negligent. Interestingly, Valero did not name or refer to ECCO in the suit, only making a generic reference to Encompass and its subcontractors.

Shortly thereafter, Encompass filed for bankruptcy. This, in turn, gave rise to an elaborate settlement where Encompass assigned to Valero its rights against Continental (its primary CGL insurer) and Columbia (its E&O insurer), which led to an arbitration between Valero and Encompass. Continental and Columbia (both CNA companies) settled with Valero in which they paid Valero \$3 million and guaranteed Valero an additional \$5.5 million. Valero executed a release in favor of Continental (Encompass's primary CGL insurer) and Columbia (Encompass's E&O insurer). Continental, the primary CGL insurer, took the position that it no longer owed Encompass a duty to defend based on policy exhaustion. Columbia, the E&O insurer, claimed it did not owe duty to defend because Encompass did not pay its SIR and so its coverage was not implicated by the loss. The defense of Encompass was accepted by its umbrella insurer, National Union, which expended \$3 million in defense costs before the Valero-Encompass dispute was settled.

After the settlement, the four insurers engaged in coverage litigation to re-allocate the \$5.7 million in defense costs expended by Encompass' primary CGL insurer, Continental (\$2.7 million) and its umbrella insurer, National Union (\$3 million). With regard to National Union, the umbrella insurer, the court applied Texas law and held that it was entitled to recover its entire

\$3 million contribution to Encompass' defense. In so doing, the court rejected the primary insurers' argument that in light of the Encompass assignment to Valero, National Union could not subrogate because it in essence "stepped into empty shoes." In this regard, the court held that:

[d]isallowing National Union to recover from the primary carriers when those carriers had an obligation to protect the insured would encourage the primary carriers to breach their duties to defend rather than place their insured's interests above their own by defending and seeking reimbursement later.

The Fifth Circuit continued by noting that "[t]he purpose and effect of the assignment . . . was not to empty Encompass's shoes but rather to assist Valero in the collection of any judgment against Encompass should Valero ultimately prevail on liability." Accordingly, the court held that National Union could proceed with its recovery effort based on contractual subrogation.

With regard to Encompass's primary CGL insurer, Continental, the court again applied Texas law and rejected Continental's argument that the earlier partial settlement with Valero exhausted its policy and relieved it of any further duty to defend. The court noted that the settlement did not conclude the dispute between Valero and Encompass, "but merely [was] an initial installment payment from one insurer."

With regard to Encompass's E&O insurer, Columbia, the court applied Texas law and rejected its argument that coverage under its policy never arose because Encompass failed to pay its \$250,000 SIR. In response, the Fifth Circuit held that:

[a]lthough it is undisputed that Encompass never paid its self-insured retention limit, the policy does not explicitly require the insured to pay the amount itself. Both Continental and National Union spent millions of dollars on Encompass's defense, thereby satisfying the self-insured retention limit. Such a limit "represents the amount of the loss that the insured is responsible for before the coverage is triggered." [citation omitted]

As it relates to subcontractor ECCO's primary CGL policy with North American (which named Encompass as an additional insured), the court applied California law and disagreed with North American's argument that because Valero did not name ECCO in its Complaint and because extrinsic facts showed that ECCO was not at fault, North American was not obligated to defend Encompass. With respect to this issue, the court found that Valero's allegations referring to faulty workmanship by Encompass "and [its] subcontractors" was "sufficient to trigger North American's duty to defend," regardless of whether extrinsic evidence exculpated ECCO from any malfeasance or wrongdoing. Accordingly, the Fifth Circuit held that "that each of the policies issued by Continental, Columbia, and North American was triggered by Valero's claims against Encompass and that all three insurers owed a primary duty to provide a complete defense."

Finally, the Fifth Circuit analyzed Continental's, Columbia's and North American's other insurance clauses (under Texas law) and excised the conflicting language contained therein. After doing so, the court held that: "Each policy provided complete, primary coverage to Encompass. Therefore, the district court's decision to prorate the defense costs equally among the three primary insurers was correct."