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MID-CONTINENT V. JHP:

The Fifth Circuit Court of Appeals narrowly construes exclusions J(5) and J(6) of the standard CGL policy

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Mid-Continent Casualty Co. v. JHP: Mid-Continent Becomes the Buffalo Bills of Insurance Law—It Never Can Win the Big Game!

On January 28, 2009, the Fifth Circuit Court of Appeals issued an opinion addressing exclusions J(5) and J(6) of the standard CGL insurance policy. *See Mid-Continent Cas. Co. v. JHP Development, Inc.*, No. 05-50796, ___ F.3d ___ (5th Cir. Jan. 28, 2009). The court affirmed the Western District of Texas' opinion in which it was found that Mid-Continent owed its insured, JHP Development, a defense and indemnity for damages awarded to TRC Condominiums, Ltd. in a state court lawsuit between JHP and TRC, stemming from JHP's defective construction of a condominium project in San Antonio. In reaching its decision, the court of appeals rejected Mid-Continent's claim that J(5) applied because four of the five condominiums in the project were left unfinished. Turning to J(6), the court said that the "that particular part" language must mean something under Texas law, and thus the exclusion did not bar coverage for damage to otherwise non-defective portions of the condominiums. Finally, the Fifth Circuit applied the Supreme Court of Texas' recent decision in *Evanston Insurance Co. v. ATOFINA Petrochemicals, Inc.*, 256 S.W.3d 660 (Tex. 2008), and held that Mid-Continent is bound by the default judgment awarded to TRC against JHP in the underlying lawsuit.

A. Background Facts

In January 1999, TRC and JHP entered into a construction contract wherein JHP agreed to build a four-story, five-unit condominium project. Only the model condominium was to be completed under the construction plans, leaving the remaining four units unfinished so that the new owner for each unit could choose how the unit was finished. By spring 2001, the model unit was completed. The remaining units still needed to be painted, floored, plumbed, electrical fixtures installed, and the HVAC systems activated.

Sometime beginning in the summer or fall of 2001, water intrusion problems developed with the condominiums. In particular, it was determined that JHP failed to properly water-seal the exterior finishes

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CASES TO WATCH:

***Pine Oak Builders, Inc. v. Great Am. Lloyds Ins. Co.*, 2006 WL 1892669 (Tex. App.—Houston [14th Dist.] July 6, 2006, pet. granted) (scope of the eight-corners rule and proper trigger theory to apply to "property damage" cases)**

***Johnson v. State Farm Lloyds*, 204 S.W.2d 897 (Tex. App.—Dallas 2006, pet. granted) (scope of the standard appraisal clause)**

***D.R. Horton—Texas, Ltd. v. Markel International Ins. Co., Ltd.*, 2006 WL 3040756 (Tex. App.—Houston [14th Dist.] Oct. 26, 2006, pet. filed) (scope of the eight-corners rule and the relationship between the duty to defend and the duty to indemnify)**

and retaining walls. As a result, large quantities of water penetrated the units, damaging building materials and interior finishes. JHP refused to repair the damage and complete the work, so TRC terminated the company's contract.

On December 12, 2002, TRC retained a substitute contractor who repaired and completed the condominiums. That contractor spent more than $400,000 investigating, demolishing, repairing and replacing the non-defective interior finishes and wiring damaged by the water intrusion.

JHP notified Mid-Continent of the problems on the TRC project and sought coverage under its CGL policy. On May 1, 2003, Mid-Continent denied coverage, claiming there was no "occurrence" or "property damage" as those terms were defined under the insurance policy. In addition, Mid-Continent alleged that various exclusions applied to bar coverage. Thereafter, in October 2003, TRC filed suit against JHP, and JHP tendered defense of the claim to Mid-Continent. Again, Mid-Continent denied coverage for the claim and refused to provide a defense. Ultimately, in December 2003, a default judgment was entered against JHP in excess of $1.5 million.

Mid-Continent then filed a declaratory judgment action against JHP and TRC, seeking a declaration that (1) JHP was not entitled to coverage; (2) no defense or indemnity duties existed; (3) TRC was not entitled to recover any sums as a third-party beneficiary or judgment creditor; and (4) the default judgment was not binding on Mid-Continent. JHP never filed an answer in the declaratory judgment action. TRC, in contrast, filed a counterclaim against Mid-Continent. Mid-Continent and TRC ultimately filed cross-motions for summary judgment on the coverage issues in the district court. That court granted TRC's motion and denied Mid-Continent's. The Western District of Texas ruled that there was an "occurrence" and "property damage," none of the exclusions applied to bar coverage and the default judgment in the underlying suit was binding on Mid-Continent.

On appeal, Mid-Continent abandoned its argument regarding the lack of an "occurrence" or "property damage" in light of the Supreme Court of Texas' opinion in *Lamar Homes, Inc. v. Mid-Continent Casualty Co.*, 242 S.W.3d 1 (Tex. 2007) (for an in-depth analysis of this case, please see Volume 1, Issue 5 of the *Insurance Law Newsletter*, available at www.vsfirm.com/publications). Instead, the insurer urged the appellate court to find that exclusions J(5) and J(6) barred coverage and that, in any event, the default judgment against its insured was not binding on Mid-Continent because there was not a fully adversarial trial.

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B. The Exclusions

Exclusions J(5) and J(6) in the standard CGL policy are as follows:

> **This insurance does not apply to:**
>
> *** * ***
>
> **j. Property damage to:**
>
> *** * ***
>
> **(5) That particular part of real property on which you or any contractor or subcontractors working directly or indirectly on your behalf are performing operations, if the 'property damage' arises out of those operations; or**
>
> **(6) That particular part of any property that must be restored, repaired or replaced because "your work" was incorrectly performed on it.**

Further language in the standard insurance policy notes that J(6) "does not apply to 'property damage' included in the 'products-completed operations hazard.'" "Your work" is defined in the policy as "work or operations performed by you or on your behalf."

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As recognized by the Fifth Circuit, both J(5) and J(6) are known as "business risk" exclusions, "designed to exclude coverage for defective work performed by the insured." *JHP*, 2009 WL 189886, slip op. at 5. Moreover, unlike exclusion L which applies to completed operations, both J(5) and J(6) apply to damages that occur during the course of construction.

1. Exclusion J(5)

After explaining the applicable legal standards under Texas law, the court turned to the applicability of the exclusions to the facts at hand. With respect to J(5), the parties were in agreement that "the use of the present tense 'are performing operations'" in the exclusion clarifies that the exclusion applies only to property damage that occurred during the performance of JHP's construction operations. The parties, however, disagreed as to whether JHP was "performing operations" when the water intrusion took place. TRC argued that JHP was not "performing operations" because construction had been suspended until the four units were purchased. Mid-Continent, on the other hand, claimed that the project involved ongoing construction because the units remained unfinished.

Citing *Lamar Homes* and *CU Lloyd's of Texas v. Main Street Homes*, 79 S.W.3d 687 (Tex. App.—Austin 2002, no pet.), as well as *The*

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***Oxford English Dictionary*, the court explained that "performing operations" means "the active performance of work." According to the court, "[t]he prolonged, open-ended, and complete suspension of construction activities pending the purchase of the condominium units does not fall within the ordinary meaning of 'performing operations.'" Further, "[a]lthough JHP intended to eventually complete construction work once the units were sold, an actor is not actively performing a task simply because he has not yet completed it but plans to do so at some point in the future." And, the cases cited by Mid-Continent actually all support that position, as none of them suggests that the exclusion applies to damage occurring during a prolonged suspension of construction work. Because JHP was not actively engaged in construction work at the time of the water intrusion, the exclusion did not apply. *JHP*, 2009 WL 189886, slip op. at 7–8.**

2. Exclusion J(6)

Turning to J(6), the court's focus was on the phrase "that particular part." TRC urged the court to find that it meant the exclusion only barred coverage for that portion of the condominium project that was the subject of the defective work at issue (i.e., the inadequately waterproofed exterior portions of the condominium units), as opposed to the otherwise non-defective work that was damaged as a result of the defective work (i.e., sheetrock, studs, wiring and flooring). Mid-Continent, on the other hand, argued that the phrase applied to the entire condominium project, and thus it excluded all the damage resulting from JHP's work.

In support of its position, Mid-Continent relied on *Southwest Tank & Treater Manufacturing Co. v. Mid-Continent Casualty Co.*, 243 F. Supp. 2d 597 (E.D. Tex. 2003), in which the court found that J(6) barred coverage for damage to an entire tank that the insured was hired to install. The Fifth Circuit, however, noted that its recent decision in *Gore Design Completions, Ltd. v. Hartford Fire Insurance Co.*, 538 F.3d 365 (5th Cir. 2008), had acknowledged that the *Southwest Tank* court "focused on the insured's work on the entire tank that was damaged, rather than on a particular part." *Id.* at 371 n.8. Accordingly, the case had no bearing on the instant analysis where the defective work at issue was performed on a discrete portion of an overall project. *JHP*, 2009 WL 189886, slip op. at 9.

***Gore*, in fact, lent support to TRC's position. In that case, an insured subcontractor incorrectly wired a component for an in-flight entertainment/cabin management system on a commercial plane. As a result, substantial damage occurred in the plane's electrical system. The Fifth Circuit rejected the insurer's argument that J(6) applied to the entire aircraft. In particular, the court found that "[the insurer's] reading of the exclusion reads out the words 'that particular part.'"**

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***Gore*, 538 F.3d at 371. The court said that if the exclusion were meant to bar coverage for the entire property, then the exclusion should not include the language "that particular part." *JHP*, 2009 WL 189886, slip op. at 9–10. As the Fifth Circuit noted:**

> ***Gore* makes clear that the "[t]hat particular part" language of exclusion j(6) limits the scope of the exclusion to damage to parts of the property that were actually worked on by the insured, but *Gore* did not address the issue presented in this case: whether the exclusion bars recovery for damage to any part of a property worked on by a contractor that is caused by the contractor's defective work, including damage to parts of the property that were the subject of only nondefective work, or whether the exclusion only applies to property damage to parts of the property that were themselves the subject of the defective work.**

***JHP*, 2009 WL 189886, slip op. at 10.**

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Turning back to the case at bar, the Fifth Circuit held that "[t]he plain meaning of the exclusion . . . is that property damage only to parts of the property that were themselves the subjects of the defective work is excluded." Further, the court said, "[t]he narrowing 'that particular part' language is used to distinguish the damaged property that was itself the subject of the defective work from other damaged property that was either the subject of nondefective work by the insured or that was not worked on by the insured at all." *Id.* at 10–11.

The court then said that even if another reasonable construction of the exclusion existed, the court would still be required under Texas law to construe it in favor of coverage. Accordingly, the court said:

> **We find that exclusion j(6) bars coverage only for property damage to parts of a property that were themselves the subject of defective work by the insured; the exclusion does not bar coverage for damage to parts of a property that were the subject of only nondefective work by the insured and were damaged as a result of defective work by the insured on other parts of the property.**

***Id.* at 11.**

After reaching its conclusion, the court clarified that its decision did not conflict with other Texas court decisions appearing to support a different interpretation. *See, e.g.*, *T.C. Bateson Constr. Co. v. Lumbermens Mutual Casualty Co.*, 784 S.W.2d 692, 694–95 (Tex. App.—Houston [14th Dist.] 1989, writ denied) (noting that the

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exclusion there was broader in scope than the standard J(6) exclusion); *Eulich v. Home Indem. Co.*, 503 S.W.2d 846, 849–50 (Tex. Civ. App.—Dallas 1973) (same). In addition, other appellate court decisions in Texas interpreting similar exclusions also supported the Fifth Circuit's finding. *See, e.g.*, *Dorchester Dev. Corp. v. Safeco Ins. Co.*, 737 S.W.2d 380, 382 (Tex. App.—Dallas 1987, no pet.) ("[I]f defective work is performed by or on behalf of the insured, and such defective work causes damage to other work of the insured which was not defective, then there would be coverage for repair, replacement or restoration of the work which was not defective."), *abrogated on other grounds by Don's Bldg. Supply, Inc. v. OneBeacon Ins. Co.*, 267 S.W.3d 20 (Tex. 2008) (for an in-depth analysis of *Don's Building Supply*, please see Volume 2, Issue 7 of the *Insurance Law Newsletter*, which can be found on our website at www.vsfirm.com/publications). The Fifth Circuit also explained that the South Carolina Supreme Court's decision in *Century Indem. Co. v. Golden Hills Builders, Inc.*, 561 S.E.2d 355 (S.C. 2002), was inapposite. There, in finding that J(6) barred coverage for water damage to an entire house and not just that portion that was defectively constructed—the exterior synthetic stucco—the court relied on South Carolina law, which gives great weight to the general purpose of commercial general liability insurance. That view, however, has been specifically rejected in Texas. *See Barnett v. Aetna Life Ins. Co.*, 723 S.W.2d 663, 666 (Tex. 1987) (finding that the mere fact that a policy is designated as a commercial general liability policy is not grounds for overlooking the actual language contained in the policy). As the Supreme Court of Texas said in *Lamar Homes*, such "preconceived notion[s] . . . must yield to the policy's actual language," and "coverage for [business risks] depends, as it always has, on the policy's language, and thus is subject to change when the terms of the policy change." *Lamar Homes*, 242 S.W.3d at 13–14.

As a result, because no allegations existed that JHP performed defective work on the interior portions of the condominiums, the damage to such property was not excluded from coverage under J(6). Rather, only the exterior finishes and retaining walls are "[t]hat particular part of any property that must be restored, repaired or replaced because [JHP's work] was incorrectly performed on it." *JHP*, 2009 WL 189886, slip op. at 14.

C. Fully Adversarial Proceeding

Having lost on the exclusions, Mid-Continent also argued that it should not be bound by the default judgment awarded against JHP in the underlying lawsuit because it did not constitute a "fully adversarial proceeding." In support of its position, Mid-Continent relied on *State Farm Fire and Casualty Co. v. Gandy*, 925 S.W.2d 696

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(Tex. 1996), in which the Supreme Court of Texas invalidated an insured's assignment of his claims against his insurer. But, as correctly noted by the Fifth Circuit Court of Appeals, the Supreme Court recently clarified in *Evanston Insurance Co. v. ATOFINA Petrochemicals, Inc.*, 256 S.W.3d 660 (Tex. 2008), that "*Gandy's* holding was explicit and narrow, applying only to a specific set of assignments with special attributes" and that "[b]y its own terms, *Gandy's* invalidation applies only to cases that present its five unique elements." (For an in-depth discussion of the *ATOFINA* decision, please see Volume 2, Issue 4 of the *Insurance Law Newsletter*). Because no assignment existed in *ATOFINA*, the Supreme Court's prior decision in *Employers Casualty Co. v. Block*, 744 S.W.2d 940 (Tex. 1988), applied. In *Block*, the Court held that an insurer who refuses to defend its insured when it has a duty to do so is bound by the amount of the judgment rendered against the insured.

Because the suit before the Fifth Circuit was not an action against defendant's insurer by plaintiff as defendant's assignee, *Gandy* was not implicated. Thus, *Block* controlled, and because Mid-Continent breached its duty to defend, it was bound by the default judgment awarded against its insured. *JHP*, 2009 WL 189886, slip op. at 15–16.

Commentary:

The Fifth Circuit's opinion in *JHP* is the latest in a growing line of cases in Texas where courts adhere to the plain language in the insurance policy while rejecting arguments about what the insurer *meant* to exclude. As a result, insureds continue to gain traction with respect to the proper interpretation of CGL policies for construction defect lawsuits. This decision is particularly significant in that it addresses the two main "course of construction" exclusions, which previously had been interpreted to broadly exclude property damage that occurred during construction.

While the Fifth Circuit's decision regarding J(5) is not earth-shattering, its analysis regarding the "that particular part" phrase in J(6) is extremely important. Insurers typically argue that the "that particular part" language—which is found in both J(5) and J(6)—is equivalent to the scope of the insured's contractual undertaking. Accordingly, for general contractors, the view was that any property damage to the project itself (i.e., the condominiums) that occurred during construction was excluded from coverage. And, since neither exclusion J(5) nor J(6) has a subcontractor exception like exclusion L, this broad interpretation oftentimes was fatal to coverage. The Fifth Circuit, however, correctly applied contract interpretation principles and limited the "that particular part" language such that it does not

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apply to otherwise non-defective work that is damaged during the course of construction—even if it is damaged as a result of the insured's defective work.

In addition, the court's adherence to the *Block*, *Gandy* and *ATOFINA* line of cases also is significant. By holding Mid-Continent to the default judgment in this case, more insurers might now think twice before denying an insured a defense outright.

Note: Visser Shidlofsky's Insurance Law Practice Group filed an amicus brief in the *JHP* case on behalf of the Texas Building Branch—Associated General Contractors of America and in support of Appellee TRC Condominiums, Ltd.

GETTING TO KNOW LEE H. SHIDLOFSKY AND THE INSURANCE LAW PRACTICE GROUP . . .

Lee H. Shidlofsky is a founding partner of Visser Shidlofsky LLP. His practice is devoted to representing and counseling corporate policyholders in the area of insurance law, risk management, contractual risk transfer, and extra-contractual issues. He is Secretary of the Insurance Law Section and holds a council position in the Construction Law Section of the State Bar of Texas. He is the author of numerous articles and seminar papers and is a frequent speaker at continuing legal education seminars in Texas and across the country. Lee has been named a "Super Lawyer" by Texas Monthly Magazine each year since 2004, including a ranking as a Top 50 attorney in the Central and West Texas Region for 2007 and 2008, and is ranked as a top insurance coverage lawyer by Chambers USA and Who's Who Legal. Lee recently was elected a Fellow of the Texas Bar Foundation.

Douglas P. Skelley and Melissa L. Kelly are associates at Visser Shidlofsky LLP. They each represent and counsel corporate policyholders in numerous insurance law matters. Doug and Melissa are members of both the Insurance Law Section and the Construction Law Section of the State Bar of Texas.

The Insurance Law Practice Group represents corporate policyholders that are in disputes with their insurance companies, provides advice to plaintiffs in complex litigation on how to best maximize an insurance recovery, and provides risk-management consultation in connection with a wide-variety of contractual risk transfer issues. The Insurance Law Practice Group handles first-party and third-party insurance claims in state and federal courts at both the trial and appellate court levels. The Insurance Law Practice Group is committed to practical and pragmatic solutions to insurance issues.

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