COVERAGE FOR DEFECTIVE CONSTRUCTION AND/OR FAULTY WORKMANSHIP: EXCLUSIONS J(5) AND J(6)

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I. INTRODUCTION

For a number of years there had been much discussion and litigation over whether claims for construction defects belonged under a liability policy at all. The debate centered around whether such claims even constituted an "occurrence" under a CGL policy. In recent decisions from the Texas Supreme Court and the Fifth Circuit Court of Appeals, the resolution of doubts in favor of the insured as to coverage and the duty to defend has come to the forefront. Allegations of defective construction and breach of contract can be sufficient to constitute an "occurrence" and trigger the duty to defend. If there is an interpretation that could trigger the duty to defend based on the pleadings and policy language, then the insured is generally owed a defense.

That does not mean that all damage from construction defects is covered. The so-called business risk exclusions still exist and in fact were always there. They are intended to eliminate coverage for the insured's own defective work. At the heart of those exclusions, along with the "your work" exclusion (exclusion l), are exclusions (j)(5) and (j)(6). The purpose of this paper is to focus on some recent developments and caselaw addressing the application of exclusions j(5) and j(6).

As explained by the Texas Supreme Court, "[e]xclusions exist for intended or expected losses, as well as for contractually-assumed liabilities . . . and for a number of so-called business risks." *Lamar Homes, Inc. v. Mid-Continent Cas. Co.,* 242 S.W.3d 1, 10 (Tex. 2007). The exclusions (j)(5) and (j)(6) generally arise in the construction context. These exclusions are as follows:

> j. Damage to Property
> "Property damage" to:
>
> (5) That particular part of real property on which you or any contractors 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.
>
> Exclusion j(6) does not apply to "property damage" included in the "products completed operations hazard."
>
> "Your work" is defined as "work or operations performed by you or on your behalf."
>
> "Products completed operations hazard" is generally defined as "property damage" occurring away from premises you own or rent and arising out of your product or your work except:
>
> (1) products that are still in your physical possession; or
> (2) work that has not yet been completed or abandoned."

These exclusions are often cited together. (j)(5) focuses on the particular part of the property the insured works on or that a subcontractor performs work on for the insured. The key language in (j)(5) is "that particular part," often given a narrow interpretation, and "performing operations," which is generally interpreted broadly. The exclusion only applies to real property damage that occurs while the insured is performing operations. Exclusion (j)(6) applies to faulty workmanship in order to restrict coverage on

risks that are typically covered by business risk insurance. (j)(6) only applies to projects that are not completed, as it excepts from the exclusion property damage included in the products completed operations hazard. Unlike (j)(5), (j)(6) does not exclude the work that a subcontractor performs for the insured. This exception was inserted into the standard CGL policy by the Insurance Services Office in 1986; more recently the Insurance Services Office issued an endorsement that can be included in a CGL policy to eliminate the subcontractor exception.

II. THE EIGHT CORNERS RULE

When determining if there is a duty to defend under a CGL policy, Texas courts apply the eight-corners rule. When an insured is sued by a third-party, a liability insurer must evaluate whether there is a duty to defend the insured against the claims by looking only at the terms of the policy and the pleadings of a third-party claimant. Examining other outside evidence will generally be prohibited. The truth or falsity of the petition's allegations will not be determinative in this examination. The duty to defend can be invoked merely by factual allegations that potentially support a covered claim. In fact, doubts as to whether there is a duty to defend must be resolved in favor of the insured. The insurer is obligated to defend the case if there is a potential claim that falls within the policy's coverage. *Gore Design Completions, Ltd. v. Hartford Fire Ins. Co.*, 538 F.3d 365, 368-369 (5th Cir. 2008).

Limitations arise when a court examines the pleadings and the policy language to determine if there is a duty to defend. Courts cannot read facts into pleadings, look outside of the pleadings or imagine factual scenarios that might trigger the coverage. However, courts can still draw inferences from the pleadings that may lead them to find coverage. *Id.*

III. CAN ALLEGATIONS OF FAULTY WORKMANSHIP OR DEFECTIVE CONSTRUCTION TRIGGER A DUTY TO DEFEND?

Interpretation of what is an "occurrence" and "property damage" must be determined from the factual allegations, not the claims asserted in the pleadings. Even allegations of faulty work or defective construction can trigger a duty to defend under a CGL policy. The Texas Supreme Court clarified how the eight corners rule should be applied to construction defect claims and how to interpret allegations to decide if a duty to defend exists with respect to such claims in *Lamar Homes, Inc. v. Mid-Continent Cas. Co.,* 242 S.W.3d 1 (Tex. 2007) and more recently in *Grimes Construction, Inc. v. Great Am. Lloyds Ins. Co.,* 248 S.W.3d 171 (Tex. 2008). It is not the most reasonable interpretation that will control. Rather, if it is possible that a claim may fall within the policy's coverage, a duty to defend arises. All doubts must be resolved in the insured's favor. Under this approach, allegations based upon a contractor's faulty work or defective construction can trigger the duty to defend.

A. Lamar Homes, Inc. v. Mid-Continent Cas. Co.

A brief review of the Supreme Court's decision in *Lamar* Homes is helpful is setting the backdrop for a discussion of issues involving coverage for construction defect claims. The issues of defective construction and faulty workmanship were the focus of the first two certified questions in *Lamar Homes*. The DiMares purchased a new house from Lamar Homes and encountered problems several years later that they attributed to defects in the house's foundation. They sued Lamar Homes and its subcontractor over the defects. *Lamar Homes*, 242 S.W.3d at 4. The Texas Supreme Court examined whether allegations of faulty or defective construction work could constitute an "accident" or "occurrence" under a CGL policy and whether allegations of damage to or loss of use of the home itself could constitute "property

damage." The Texas Supreme Court concluded that the answer to both questions was yes and that such allegations could trigger a duty to defend. *Id.* at 4.

An occurrence under a CGL policy is defined as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions." *Id.* at 6. No further definition is provided. When terms are not defined in a policy then they are given their generally accepted or commonly understood meaning. *Id.* at 8. In this case, the carrier argued that direct economic damages flowing from the contract are presumed to have been foreseeable. However, the Court rejected this position. While an accident or occurrence does not include an intended injury or when "the circumstances confirm that the resulting damage was the natural and expected result of the insured's actions," whether an insured's faulty workmanship was intended or accidental depends upon the facts and circumstances of each individual case. To determine if there is a duty to defend, the complaint will provide the facts and circumstances to be examined. *Id.* In this case, the complaint alleged that the defective construction was a product of Lamar's negligence; thus it alleged an "occurrence." *Id.* at 9-10.

The next question examined was whether the occurrence caused "property damage." The policy at issue in *Lamar Homes* defined "property damage" as "physical injury to tangible property, including all resulting loss of use of that property." *Lamar Homes*, 242 S.W.3d at 6. The house fell within the definition of tangible property. The DiMares' specific allegations were that Lamar negligently designed and constructed the home's foundation and that Lamar's defective workmanship caused the sheetrock and stone veneer to crack. The Court explained that the cracked sheetrock and stone veneer constituted allegations of "physical injury" to "tangible property." *Id.* at 10.

The Court rejected applying the economic-loss rule to determine whether there is coverage; this would bring the focus of the inquiry back to the type of claim filed. The economic-loss rule prevents recovery in tort for economic losses that result from a party's failure to perform under a contract. The Court held that the rule constitutes a liability defense or remedies doctrine, not a rule for coverage interpretation or a defense to coverage under the policy. A CGL policy makes no distinction between tort or contract damages. The policy's actual language must be examined and compared to the complaint's factual allegations, not the type of claims asserted. *Id.* at *12-*13. Whether a duty to defend arises must be determined through the eight-corners-rule. "The proper inquiry is whether an 'occurrence' has caused 'property damage,' not whether the ultimate remedy for that claims lies in contract or in tort." *Id.* at *15.

As stated above, "property damage" consists of physical injury to tangible property and includes loss of use of that tangible property. Claims for damage resulting from an insured's defective performance or faulty workmanship can constitute an "occurrence" under a CGL policy when the "property damage" "results from the 'unexpected, unforeseen or undersigned happening or consequence of the insured's negligent behavior.'" *Id.* at *16 *quoting Federated Mut. Ins. Co. v. Grapevine Excavation, Inc.*, 197 F.3d 720, 725 (5th Cir. 1999). Further, allegations of only damage to or loss of use of the home are sufficient allegations of "property damage" to trigger the duty to defend under a CGL policy. *Id.* at 16.

B. Grimes Construction, Inc. v. Great Am. Lloyds Ins. Co.

The Texas Supreme Court revisited the duty to defend issue based upon allegations of faulty workmanship in *Grimes Constr., Inc. v. Great Am. Lloyds Ins. Co.*, 248 S.W.3d 171 (Tex. 2008). In that case, the Coxes contracted with Grimes to construct their house. After

Grimes sued the Coxes for payment, the Coxes filed a counterclaim alleging faulty construction of the house, failure to complete the house timely, false representations and failure to construct the house in a good and workmanlike manner. The Coxes' claims included breach of contract, breach of express and implied warranties, fraud, misrepresentation and negligent misrepresentation. *Grimes Constr., Inc. v. Great Am. Lloyds Ins. Co.*, 188 S.W.3d 805, 808 (Tex.App.—Fort Worth 2006, rev'd).

In the pre-*Lamar Homes* appeal, the appellate court determined that there was no duty to defend. The Fort Worth Court of Appeals applied the eight corners rule and focused on the factual allegations. The court of appeals explained that the rule requires that the allegations in the pleadings be given a liberal interpretation in the insured's favor and that doubts be resolved in the insured's favor. *Id.* at 809. The appellate court determined that the negligence claims appeared to stem from Grimes' contractual and warranty obligations. The facts supported a conclusion that the alleged negligence was only an extension of the other claims as it was only a recharacterization of the breach of contract and warranty claims. The Coxes' injury was that they did not receive the house that they were promised and had paid for. *Id.* at 812. The appellate court distinguished the line of cases holding that allegations of damage resulting from faulty workmanship do constitute an occurrence; it found that the only damage alleged was to the work that Grimes was to complete pursuant to its contract with the Coxes. *Id.* at 812-813. According to the court of appeals, it was reasonably foreseeable that not complying with the construction plans and negligently performing construction duties would cause damages like the Coxes alleged. *Id.* at 813. The appellate court also concluded that the remaining claims did not constitute an occurrence. *Id.* at 814-818.

In deciding *Grimes*, the Texas Supreme Court looked back to its analysis of property damage caused by an occurrence in *Lamar Homes*. As discussed above, "allegations of unintended construction defects might constitute an 'accident' or 'occurrence' under the GCL policy" and "allegations of damage to or loss of use of the home itself might also constitute 'property damage.'" *Grimes Constr.*, 248 S.W.3d at 172 *citing Lamar Homes*, 242 S.W.3d at 4. In *Grimes*, labels of tort or contract claims would not override the language of the policy. The Texas Supreme Court reversed the court of appeals' decision that defective work constituted a contract claim outside the scope of the CGL policy. *Grimes Constr.*, 248 S.W.3d at 172.

As shown by the Texas Supreme Court's opinions, allegations of faulty or defective workmanship can constitute an occurrence under a CGL policy, and allegations of damage to or loss of use of property establish property damage. However, the fact that there is property damage caused by an occurrence does not end the inquiry. Even when the allegations are sufficient to establish an occurrence that caused property damage, the question remains as to whether the exclusions of the CGL policy will bar coverage, particularly (j)(5) and (j)(6).

IV. EXCLUSIONS (J)(5) AND (J)(6)

The focus of coverage disputes over construction defect claims has now necessarily shifted back to the business risk exclusions. Exclusions j(5) and j(6) are now some of the principle battlegrounds for such disputes.

A. Exclusion j(6) – What Is Included and What Is Not

The Fifth Circuit recently addressed how the exclusions could affect a finding of a duty to defend based upon the allegations and the policy language under the eight corners rule. In *Gore Design Completions, Ltd. v. Hartford Fire Ins. Co.*, 538 F.3d 365, (5th Cir. 2008), Gore contracted with Orient to perform work on a Boeing 737. Gore subcontracted the

installation and engineering of an in-flight entertainment/cabin management system to BaySys. In turn, BaySys subcontracted the work to AeroTask. Orient sued Gore and AeroTask but not BaySys; however, Orient alleged that BaySys and AeroTask were agents, partners, joint venturers or otherwise acting on behalf of Gore. Orient claimed that Gore and AeroTask improperly joined the jet's electrical power panels. Orient further alleged that the jet was grounded as a result of damage to the electrical system and electrical equipment. Gore was named as an additional insured under BaySys' policy with Hartford and tendered the defense to Hartford. Hartford asserted that there was no duty to defend. *Id.* at 367-368.

The Fifth Circuit concluded that Hartford owed Gore a duty to defend it in the litigation. Gore was an additional insured with regards to BaySys' operations or work. In the policy, "your work" was defined as "work or operations performed by you or on your behalf." *Id.* at 369. The statement of claim implicated BaySys' work due to the allegations that BaySys was employed by Gore and acting as its agent. There are other ways to read the allegations, but under the eight corners rule doubt must be resolved in favor of the insured. In giving the allegations a liberal interpretation, Hartford's duty to defend Gore was triggered. *Id.*

After determining there was property damage caused by an occurrence, the Fifth Circuit then turned to examining whether an exclusion would prevent coverage. If the plaintiff's allegations place the claim within a coverage exclusion, there is no duty to defend. Exclusions are narrowly construed, and inferences are drawn in favor of the insured. Courts must adopt the construction that most favors the insured. Limitations on liability will be strictly construed against the insurer. *Id.* at 370-371.

The Fifth Circuit examined whether (j)(6) would cover all of the plane or only part. (j)(6) excludes from coverage property damage to "that particular part of any property that must be restored, repaired or replaced because 'your work' was incorrectly performed on it." *Id*. at 371. Hartford argued that the exclusion applied to the entire jet, not just the electrical system. The Fifth Circuit interpreted Hartford's argument as leaving out the language "that particular part." If Hartford's interpretation was reasonable, so was the interpretation that (j)(6) would only exclude damage to the electrical system from coverage. The statement of claims alleged damage to the aircraft beyond the electrical system. As a result, the exclusion did not apply to eliminate the duty to defend in this case, as at least some of the claims were covered and not excluded. *Id.* at 371-372. The Fifth Circuit noted that if Hartford wanted to exclude damages to the entire property after an insured worked on part of the property, then the exclusion should state: "Property damage to property that must be restored, repaired or replaced because your work was performed on any part of it." *Id.* at 371. The interpretation of (j)(6) and narrowing its reach to only the electrical system is consistent with resolving doubts in favor of the insured and strictly construing the exclusion against the insurer.

B. Exclusion j(5) – Ongoing Operations v. Completed Operations

The Fifth Circuit also addressed exclusions (j)(5) and (j)(6) in the recently published case of *Mid-Continent Casualty Co. v. JHP Development, Inc.*, 2009 U.S. App. LEXIS 1889 (5th Cir. 2009) and tackled the issue of what constitutes completed operations for purposes of the application of j(5). In this case, JHP entered into a contract with the owner TRC to construct condominiums. The plans called for the units to remain partially unfinished until they were sold, so the new owner could decide how to finish the unit. The model unit was completed in spring 2001, and water intrusion problems began in summer or fall of 2001. The water intrusion allegedly

resulted from JHP's failure to properly water-seal the exterior finishes and retaining walls. Water penetrated the interior through ceilings, walls and under doors and damaged interior finishes and contiguous building materials. JHP notified Mid-Continent of the problems, and Mid-Continent denied coverage on the basis that there was no "occurrence" or "property damage" under the policy and that various exclusions applied. A default judgment was entered against JHP for $1.5 million. *Id.*, 2009 U.S. App. LEXIS 1889, *2-*4. The District Court held that exclusions (j)(5) and (j)(6) did not apply. *Id.*, 2009 U.S. App. LEXIS 1889, *6.

As to exclusion (j)(5), the parties agreed that the language "are performing operations" meant that the exclusion only applied to property damage that occurred during the performance of JHP's construction operations. The dispute arose over whether JHP was "performing operations" when the water intrusion occurred. TRC argued that JHP was not performing operations when the water intrusion occurred because construction operations had been suspended and were not actively occurring at the time. Mid-Continent took the position that the project remained incomplete as four units had to be finished and JHP was "performing operations" still. *Id.*, 2009 U.S. App. LEXIS 1889, *11.

JHP was not actively "performing operations" at the time the water intrusion occurred. As noted by the Fifth Circuit, "[t]he ordinary meaning of 'performing operations' is the active performance of work." *Id*. The work halted pending the purchase of the condominium units. This did not fall within the normal meaning of "performing operations" as there was a total cessation of work for the foreseeable future; it was not a temporary halt of a day or a few days. JHP planned on completing the work once the units were sold, but "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." *Id.*, 2009 U.S. App. LEXIS 1889, *12. As a result, exclusion (j)(5) did not apply. *Id.*

The interpretation of exclusion (j)(6) centered on the key language "that particular part." Mid-Continent argued that the exclusion covered all property damage to the condominiums that resulted from JHP's defective work. TRC took the position that the exclusion only applied to damage that was the subject of the defective work and not to areas that were damaged but were not the subject of the defective work. *Id.*, 2009 U.S. App. LEXIS 1889, *13-*14. The Fifth Circuit followed its analysis in *Gore*. The language "that particular part" limited exclusion (j)(6)'s scope "to damage to parts of the property that were actually worked on by the insured." *Id.*, 2009 U.S. App. LEXIS 1889, *16. However, the Fifth Circuit went further and examined the issue of whether the exclusion bars recovery for damage to property that a contractor worked on when the damage is caused by the contractor's defective work.

The Fifth Circuit explained the meaning of exclusion (j)(6) further as follows:

> The plain meaning of the exclusion—property damage to "[t]hat particular part of any property that must be restored, repaired or replaced because 'your work' was incorrectly performed on it"—is that property damage only to parts of the property that were themselves the subjects of the defective work is excluded. This becomes clear when the exclusion is broken down into its component requirements: the "particular part" referred to is the part of the property that (1) must be restored, repaired or replaced (2) because the insured's work was incorrectly

> performed on it. The second requirement makes clear that the "particular part" of the property must have been the subject of the incorrectly performed work. The 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., 2009 U.S. App. LEXIS 1889, *16-*17. The Court determined that exclusion (j)(6) bars coverage only for property damage to areas that were the subject of defective work by the insured. The exclusion did not extend to property damage in areas that were only the subject of nondefective work by the insured. *Id.*, 2009 U.S. App. LEXIS 1889, *18. In this case, the petition lacked any allegations that JHP performed defective work on the damaged interior portions of the condominiums. The interior damage resulted from JHP's failure to property water-seal the exterior finishes and retaining walls. As a result, exclusion (j)(6) applied to the exterior finishes and retaining walls, but it did not extend to the damaged interior portions. *Id.*, 2009 U.S. App. LEXIS 1889, *23.

The Fifth Circuit's opinion follows those of the Texas Supreme Court and will find coverage, even in light of exclusions (j)(5) and (j)(6), if there is an interpretation that allows a claim to potentially fall within the policy's coverage. The allegations in *Gore* and *JHP Development* did not limit damage to occurring during ongoing operations. Further, the allegations of defective construction or faulty work were narrowed to the specific area that caused the damage. The allegations were narrow enough that they did not allege that all work performed by the contractor was defective and caused damage. As a result, the resulting damage extended beyond the area where the defective work allegedly occurred and triggered the duty to defend.

V. INDEMNITY – WHAT IS ACTUALLY COVERED

The broad deference given to the insured and the potential for coverage triggering a duty to defend does not necessarily carry over to enforcement of the policy once a judgment is entered. The right to indemnity dollars and the duty to indemnity are interpreted more narrowly. Despite the need to resolve ambiguity in favor of the insured, a clear fact remains that coverage will not extend to a product that the owner bargained for and did not receive under the contract.

The recent case of *Lamar Baptist Church of Arlington, Inc. v. St. Paul Fire and Marine Ins. Co.*, 2009 U.S. Dist. LEXIS 9470 (N.D. Tex. 2009) addressed what is property damage along with the applications of exclusions (j)(5) and (j)(6). In this case, Lamar contracted with Coronado Builders to construct an addition on the Church. Coronado subcontracted the roofing work. According to Lamar, construction began in 2000, and roof leaks began in winter or spring 2001 and continued until October 2007. Lamar alleged that the leaks resulted from faulty roof and gutter construction. Lamar obtained a judgment against Coronado and sought recovery of the judgment from Lamar's policies with St. Paul. St. Paul sought summary judgment on several grounds, including application of exclusions (j)(5) and (j)(6). *Id.*, 2009 U.S. Dist. LEXIS 9470, *1-*6.

Property damage was defined in the policy at issue as:

> physical damage to tangible property of others, including all resulting loss of use of that property; or

> loss of use of tangible property of others that isn't physically damaged.

Id., 2009 U.S. Dist. LEXIS 9470, *15. St. Paul argued that there was no damage to the property of others as the resulting damage occurred to Coronado's own work, which consisted of the entire church addition. *Id.* However, the Court narrowed the scope of work at issue to the work performed by the subcontractor, namely installation of the roof and gutter system, and found there would still be damage to the property of others. In this case, the extend of the damage to other property was defined in the judgment; the other property damaged was ceiling tiles and carpet that suffered water damage. Damage to the roof and gutter system would not be "physical damage" to property as it arose simply due to Lamar's failure to receive the kind of roof and gutter system that it bargained for. *Id.*, 2009 U.S. Dist. LEXIS 9470, *20-*21.

There were indications in the evidence that at least some of the damage resulted from Coronado's completed work. The Court examined the application of exclusions (j)(6) and (j)(5). The policy's definition of "your work" included the work that subcontractors performed for Coronado. The Court interpreted exclusion (j)(6) to exclude from coverage "the financial loss suffered by Lamar because of the failure of Coronado to provide the kind of roof and gutter system Lamar expected to receive under its contract." *Id.*, 2009 U.S. Dist. LEXIS 9470, *22-*23. There would still be coverage for water damage to others' property, such as the ceiling tiles and carpet, so long as the damage was suffered by Lamar after the work had been completed. As with (j)(6), the Court interpreted the purpose of (j)(5) to be preventing coverage for losses suffered by Lamar simply because Coronado did not provide what it promised to under the contract. Again, the exclusion still allowed coverage for water damage resulting from leaks that occurred after the completion of construction. *Id.*, 2009 U.S. Dist. LEXIS 9470, *24.

VI. CONCLUSION

The Texas Supreme Court and the Fifth Circuit's recent opinions show that the duty to defend will be triggered when the plaintiff's allegations set forth a potential claim that falls within the policy's coverage. This should hold true even in the face of other conflicting and reasonable interpretations that lead to the conclusion that the duty was not triggered. The emphasis is placed on resolving doubts in favor of the insured. Allegations of faulty work and defective construction will not prevent a duty to defend from arising. The application of exclusions (j)(5) and (j)(6) will be limited at this early stage, as the duty to defend is to be defined broadly and exclusions are to be construed narrowly.

With regard to actual coverage and a duty to indemnify, the long established rule of thumb that damage to other work is covered remains true. If the allegations establish damage beyond the area subject to the defective work occurred and outside of the ongoing operations period, there will be a finding of property damage and coverage. As the recent case of *Lamar Baptist Church* shows, exclusions j(5) and j(6) can be applied to limit coverage, but what constitutes the insured's work will not be construed too broadly.

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