In the

United States Court of Appeals

For the Seventh Circuit

No. 22-1933

FRANKENMUTH MUTUAL INSURANCE COMPANY,

Plaintiff-Appellee,

v.

FUN F/X II, INC. and CAO ENTERPRISES II, LLC,

Defendants-Appellants.

Appeal from the United States District Court for the
Northern District of Indiana, South Bend Division.
No. 3:20-cv-00076-DRL — **Damon R. Leichty**, *Judge*.

ARGUED DECEMBER 1, 2022 — DECIDED FEBRUARY 28, 2023

Before EASTERBROOK, HAMILTON, and KIRSCH, *Circuit Judges*.

HAMILTON, *Circuit Judge*. Appellants Fun F/X II, Inc. and Cao Enterprises II, LLC (collectively "Fun F/X") sought insurance coverage after a warehouse fire. The relevant insurance policy issued by appellee Frankenmuth Mutual Insurance Company provides that it does not cover losses if prior to the fire the policy holder knew of a suspension or impairment in an automatic sprinkler system yet failed to notify

Frankenmuth of the issue. Based on this policy exclusion, the district court granted summary judgment for Frankenmuth. We affirm.

I. *Undisputed Facts and Procedural History*

Fun F/X II, Inc. is a costume and theatrical supply retailer that stored its inventory in a warehouse in South Bend, Indiana owned by Cao Enterprises II, LLC. Victor Cao is the sole member of Cao Enterprises II, LLC and the sole stockholder of Fun F/X II, Inc. Cao purchased the warehouse in 1999. It then had a functional sprinkler system with a working supply of water. Cao replaced the sprinkler heads around 2004 and hired inspection companies for routine system testing. In 2016, an inspector from Legacy Fire Protection found no problems.

But when the same inspector returned on September 28, 2017, the sprinkler system had no water pressure. The inspector notified Cao, and the two called South Bend Water Works immediately. The person they reached could not explain why no water was flowing and had no record of the water being shut off. Nothing more was done to address the lack of water flow for almost two months.

On November 15, 2017, Cao spoke with the city fire inspector to try to solve the problem. Cao said he had asked his inspection company to investigate how to turn the water back on and that he needed to follow up to see if it had found a solution. The city fire inspector answered Cao's questions but did not know how to restore the water. The conversation ended with Cao saying he would contact the city again.

Cao then called the South Bend Water Works office and had a five- to ten-minute conversation with the operator who

answered the phone. The operator told him there was no record of the water being disconnected at the warehouse's address. Cao asked the operator to restore the water and "assumed that she was going to take it to the higher level and figure out what was going on." Cao never heard from any water works personnel and did nothing else to check whether the water was in fact restored. No one ever told Cao the source of the problem, let alone that the problem was fixed.

The next year, a different employee from Legacy Fire Protection performed the annual inspection in the warehouse. Cao was not present for that September 2018 inspection and was not notified of any problems.[1]

A fire destroyed the warehouse and all of its contents on July 26, 2019. Fun F/X claimed losses exceeding $7 million. The sprinkler system still did not have any water flowing to it. After the fire, the source of the problem was discovered: The city apparently had cut and capped the pipe supplying the sprinkler system in April 2017 when the building next door was demolished. Cao was told that the worker cutting the pipe incorrectly believed the Fun F/X warehouse was being demolished as well.[2]

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[1] An invoice suggests that the 2018 inspection covered only the fire extinguishers and not the sprinkler system. But even if the inspection was supposed to include the sprinkler system, the inspection's scope would not change the analysis or outcome of this dispute between insurer and insureds.

[2] Counsel for Fun F/X said at oral argument that plaintiffs have a separate lawsuit pending against the City of South Bend related to the warehouse fire. This opinion is narrowly focused on whether Cao failed to report a known system impairment to his insurer as required for insurance

Cao filed a claim under an insurance policy issued by Frankenmuth Mutual Insurance Company with both Fun F/X II, Inc. and Cao Enterprises II, LLC as named insureds. The policy contained an exclusion providing that Frankenmuth "will not pay for loss or damage caused by or resulting from fire if, prior to the fire, you: 1. Knew of any suspension or impairment in any protective safeguard listed in the Schedule above and failed to notify us of that fact." The referenced schedule listed automatic sprinkler systems—defined to include "Any automatic fire protective or extinguishing system"—as protective safeguards. It is undisputed that Cao never notified the insurer after he learned in September 2017 that the sprinkler system lacked a working water supply. It is also undisputed that no one ever told Cao before the fire that the water flow had been restored.

Invoking diversity jurisdiction under 28 U.S.C. §1332, Frankenmuth filed this action in the Northern District of Indiana seeking a declaratory judgment that it did not owe insurance coverage to Fun F/X for losses from the fire. Fun F/X asserted a counterclaim for breach of the insurance policy. Both Fun F/X and Frankenmuth filed summary judgment motions. The district court granted summary judgment in favor of Frankenmuth based on the policy's notice-of-impairment exclusion. *Frankenmuth Mut. Ins. Co. v. Fun F/X II, Inc.*, 601 F. Supp. 3d 330, 343–44 (N.D. Ind. 2022). The court found the undisputed facts showed an "impairment" in the sprinkler system—the system had no water flowing to it—

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coverage. Nothing we say here is intended to express any finding as to the city's potential liability.

and that Fun F/X, through Cao, knew of this impairment yet failed to notify Frankenmuth. This appeal followed.

II. *Analysis*

When a district court interprets an insurance policy to decide a motion for summary judgment, we review the decision de novo. E.g., *Atlantic Casualty Ins. Co. v. Garcia*, 878 F.3d 566, 569 (7th Cir. 2017). A grant of summary judgment is appropriate if "there is no genuine dispute as to any material fact and the movant is entitled to judgment as a matter of law." Fed. R. Civ. P. 56(a). The parties agree that Indiana law applies.

Under Indiana law, insurance policies are generally construed using familiar contract analysis rules and the interpretation is often a question of law. E.g., *Home Federal Savings Bank v. Ticor Title Ins. Co.*, 695 F.3d 725, 729 (7th Cir. 2012); see also, e.g., *Ebert v. Illinois Casualty Co.*, 188 N.E.3d 858, 863–64 (Ind. 2022). "Policy terms are interpreted from the perspective of an ordinary policyholder of average intelligence." *Allgood v. Meridian Security Ins. Co.*, 836 N.E.2d 243, 246–47 (Ind. 2005), quoting *Burkett v. American Family Ins. Grp.*, 737 N.E.2d 447, 452 (Ind. App. 2000). Where the policy language is unambiguous, plain meaning controls. *Ebert*, 188 N.E.3d at 864. Our "power to interpret contracts does not extend to changing their terms and we will not give insurance policies an unreasonable construction to provide additional coverage." *Briles v. Wausau Ins. Cos.*, 858 N.E.2d 208, 213 (Ind. App. 2006). "By contrast, courts may construe—or ascribe meaning to—ambiguous policy terms only." *Erie Indem. Co. v. Estate of Harris*, 99 N.E.3d 625, 630 (Ind. 2018). A provision is ambiguous if "reasonably intelligent policyholders would honestly disagree on the policy language's meaning." *Id.* Disagreement

among the parties about the meaning of a term does not render that term ambiguous. *Circle Block Partners, LLC v. Fireman's Fund Ins. Co.*, 44 F.4th 1014, 1018 (7th Cir. 2022), citing *G&G Oil Co. of Ind. v. Cont'l Western Ins. Co.*, 165 N.E.3d 82, 87 (Ind. 2021).

A. *The Policy Exclusion*

The outcome of this case hinges on whether the notice-of-impairment exclusion applies. Indiana law instructs that the burden is on the insurer to demonstrate that a claim is barred by an exclusion. *Telamon Corp. v. Charter Oak Fire Ins. Co.*, 850 F.3d 866, 869 (7th Cir. 2017). Indiana law also requires that policies express coverage limitations clearly. *State Auto. Mut. Ins. Co. v. Flexdar, Inc.*, 964 N.E.2d 845, 848 (Ind. 2012). If an exclusion provision is genuinely ambiguous, it must be construed strictly against the insurer. *Id.*

Here, the notice exclusion bars coverage if the insured "Knew of any suspension or impairment in any protective safeguard … and failed to notify [Frankenmuth] of that fact." This provision is clear and easy to apply to the facts at hand. Cao admits that he knew there was no water flowing to the sprinkler system on at least two occasions: the September 2017 inspection and his November 2017 communications with the city fire inspector. He admits that no one ever told him that water flow had been restored. Cao also admits that he never told Frankenmuth about this lack of water flow. Under these facts and the policy's plain language, we agree with the district court that the exclusion bars coverage. We next address Fun F/X's arguments to the contrary.

B. *Suspension or Impairment "In" the Sprinkler System*

The exclusion requires notice upon learning of a "suspension or impairment in" the sprinkler system. Fun F/X characterizes the lack of water flow as "the 2017 impairment," acknowledging that the word impairment does describe the situation. Yet Fun F/X asserts that the "impairment which occurred in our case arguably did not occur within the Fun F/X sprinkler system" because the pipe was cut and capped in a location that Fun F/X claims was outside its own sprinkler system.

The district court rejected this argument, describing it as "hyperfocus[ing] on a perceived difference between 'in' and 'to' not borne out by [these words'] plain meaning or the policy's intent." *Frankenmuth Mut. Ins. Co.*, 601 F.Supp.3d at 343. We agree with the district court and see no merit in (or to) Fun F/X's argument. A reasonable policyholder of average intelligence would not read the exclusion to draw a distinction between two scenarios, one where not a drop of water flows to the system due to a break in a pipe an inch from the first sprinkler head, and another where not a drop of water flows to the system due to a break just outside the warehouse's property line. Such a forced distinction would hinder rather than promote the notice exclusion's obvious purpose. The notice exclusion exists because Frankenmuth is concerned with whether the sprinkler system will actually protect the insured property in a fire. This fundamental concern with the effectiveness of fire protection systems is not affected by the precise location of any malfunction.

A reasonable policyholder confronted with a sprinkler system incapable of releasing any water would respond "yes" if asked whether there is a "suspension or impairment in" that

system. The answer would not hinge on the precise location of the source of the problem because a reasonable person considering whether there is a "suspension in" a system looks to whether the system can perform its function. Here, the sprinkler system's function was to deliver water in the event of fire. When Cao learned that there was no water in the system, he learned that there was a "suspension or impairment in" the system and needed to report the problem to Frankenmuth if he wanted to keep the fire insurance in effect.

This case illustrates exactly why Frankenmuth requires such notice: It wants the opportunity to verify that problems are fixed. Cao may have been satisfied with his "no news is good news" approach of assuming (a) that an unidentified water works official whom he spoke with once by phone would fix the unknown problem without contacting him again, and (b) that silence from a new inspector indicated restored water flow. But if Frankenmuth had been given the opportunity to get involved, it might have required that someone actively confirm water was flowing.

Fun F/X does not point out an ambiguity in the insurance policy because no reasonable reader would adopt Fun F/X's interpretation narrowing the exclusion's application to components within the sprinkler system based on the policy's use of the word "in." See *Beam v. Wausau Ins. Co.*, 765 N.E.2d 524, 528 (Ind. 2002) (showing of ambiguity requires that "reasonable persons" could disagree over interpretation, as "ambiguity is not affirmatively established simply because controversy exists and one party asserts an interpretation contrary to that asserted by the opposing party") (citations omitted). There is no genuine factual dispute on the decisive question: Whether Fun F/X knew of a suspension or impairment in the

sprinkler system prior to the fire and failed to report that problem to Frankenmuth.

C. *Timing of Cao's Knowledge of the Lack of Water Flow*

Next, Fun F/X argues that notice was not required because Cao did not know of the impairment or suspension at the time of the July 2019 fire. Fun F/X contends that Cao reasonably believed there was water flowing to the system by that time because he had asked the city water works department to fix the problem in November 2017 and was not notified of any problems after a 2018 inspection.

This argument is a non-starter. The notice-of-impairment exclusion bars coverage if "prior to the fire" the insured knew of a "suspension or impairment in" the sprinkler system and did not notify Frankenmuth. Under the policy's language, the insured's knowledge of the status of the problem at the time of the fire is not controlling. Cao admits that he knew of the lack of water flow on at least two occasions in 2017. On each occasion, he was obliged to notify Frankenmuth that his sprinkler system had no working water source.

The argument flags a more difficult issue that we might face under different facts. Suppose Cao had been given some appropriate basis for believing the problem was fixed but never notified Frankenmuth of the problem or the fix. The policy exclusion does not say that a failure to notify is cured when the underlying problem is solved. In fact, the policy says nothing about whether failure to notify can ever be cured. Counsel for Frankenmuth took the strong position at oral argument that under the policy's terms, a failure to notify promptly could exclude coverage for the rest of time. We wonder whether a lack of compliance with a notice exclusion

can bar coverage indefinitely, even after the underlying problem has been fixed. But on the facts here, the lack of notice plainly bars coverage. The problem that Cao failed to report in 2017 was the same problem that rendered the sprinklers useless during the fire in 2019.

D. *Exception to the Exclusion*

Finally, Fun F/X argues that the policy's exception to the notice-of-impairment exclusion applies. The district court found that Fun F/X waived this argument. *Frankenmuth Mut. Ins. Co.*, 601 F. Supp. 3d at 342 n.4. Regardless of waiver, the exception does not help Fun F/X avoid the notice requirement.

The exception provides: "If part of an Automatic Sprinkler System … is shut off due to breakage, leakage, freezing conditions or opening of sprinkler heads, notification to us will not be necessary if you can restore full protection within 48 hours." Fun F/X argues that this exception applies because the Rules and Regulations governing the Municipal Utilities for the City of South Bend require reconnection of water service "at least within one (1) working day after it is requested to do so." South Bend Board of Public Works, City of South Bend Municipal Utilities Rules and Regulations § VIII(D) (2017). Cao called the city the day that he learned of the lack of water flow. He claims that the problem should have been resolved quickly enough that he should not have needed to provide notice to Frankenmuth.

This argument ignores the timing of Cao's knowledge. The initial September 2017 phone call to the city did not yield a promise to restore the water. In fact, the person Cao spoke with had no record of the water being turned off. Nothing about that call indicated that the unknown problem could be

fixed in one day. No one from the city followed up with Cao or notified him that the water had been restored. No further action was taken to try to restore the water for nearly two months.

In November 2017, Cao called the city fire inspector. In Cao's own words, he made that November call because "I didn't know why the water was off or how to get it back on." This statement is not consistent with a belief that the problem should have been solved by the prior phone call or that the problem could be solved in the next 48 hours. When Cao called South Bend Water Works in November, he was once again told the city had no record of the water being turned off and did not know why it was not flowing. The request to restore water flow was obviously not a simple one to fulfill, and no one ever gave Cao the impression that the problem could be solved within a certain time. Given the timeline and content of communications about restoring the water, Cao cannot rely on the 48-hour exception to the notice-of-impairment requirement.

Conclusion

Because the notice-of-impairment exclusion bars coverage, we do not address other issues raised, including whether the cut and capped pipe was part of the sprinkler system that Fun F/X was required by the policy to maintain. It is unfortunate that Cao's calls to city officials did not lead to further investigation or resolution of the water supply problem. It is also unfortunate that the 2018 inspection did not once again bring the problem to Cao's attention. But these unfortunate facts do not change that Cao had knowledge in September and November of 2017 that the system had no water flowing

to it yet never reported that impairment to Frankenmuth nor was told reliably that the problem had been fixed.

The judgment of the district court is AFFIRMED.