

Coverage You Didn't Know You Had: Product Defects

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Agenda

- ❑ Positions
- ❑ Policy Language- Stage 1
 - Occurrence
 - Property Damage
- ❑ Policy Language – Stage 2
 - Business Risk Exclusions



Positions

Insurer View

- No coverage for defective products under CGL policies

Policyholder View

- Coverage for defective products resulting in property damage under CGL policies



Positions

- ❑ Insurer Arguments against Coverage
 - CGL policies are not warranties
 - These are contractual claims not liability claims
 - This is a business expense
 - Damages are solely for economic loss
 - Integrated System is entirely PH's product and excluded



Positions

- ❑ Policyholder Arguments for Coverage
 - The damage was unintended and unforeseen
 - There is coverage unless the defect was intended
 - The CGL policy makes no distinction between tort and contractual damages
 - Adopting the insurer's reasoning would make the coverage illusory
 - Damage to third party property
 - Integrated system or altered product is not PH's product

Policy Language

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“Checking your policy, I see you are insured for fire, water storms, auto, medical and disability...but not zombies.”

Policy Language

- ❑ The standard CGL policy provides coverage for “**property damage**” that is caused by an “**occurrence**”

Occurrence

□ Definition:

- “an accident, including continuous or repeated exposure to substantially the same general harmful conditions.”
- “accident” is not defined.
- Courts require fortuity or unexpected, unforeseen event from the insured’s perspective.

□ Inquiry: Is it foreseeable from the insured standpoint?

Ohio

- ❑ *Westfield Ins. Co. v. Custom Agri Sys., Inc.* 2012-Ohio-4712, 133 Ohio St.3d 476 (2012)
- ❑ Held that claims of faulty workmanship, standing alone, are not claims for “property damage” caused by an “occurrence.”
 - Focused on doctrine of fortuity
 - Damage only to insured’s product/work
 - Coverage for consequential damages
- ❑ Dissent



Property Damage

❑ Defined as

- “[p]hysical injury to tangible property including all resulting loss of use of that property.”
- What is physical injury?



❑ General Rule:

- There is coverage for damage to other’s property caused by the insured’s defective product, but there may not be coverage for damage to the insured’s work or product.

Property Damage



- ❑ PH had contract to send egg-free non-fat dry milk (NFDM) to Nature's One.
- ❑ PH inadvertently sent NFDM containing egg
- ❑ Nature's One destroyed formula made with it
- ❑ PH sought coverage
- ❑ Holding: no physical injury to tangible property – Nature One just couldn't market it as egg-free

Example 1

- ❑ PH had additive to reduce disease, but stunted chicken growth resulting in lower meat production, increased feed costs, and increased processing costs. The undersized chickens were nevertheless sold for human consumption, although not at the sizes normally anticipated.
- ❑ Trial Court found no coverage because customers suffered only “economic loss” and damages “were entirely foreseeable,

Example 1 (cont.)



- Holding that adverse effects to chickens caused by defective chicken feed additive was property damage caused by an occurrence
 - Phibro was surprised by stunted growth of the Aviax-ingesting chickens = accident = “occurrence”
 - stunted growth represents harm to the physical condition of the chickens = property damage
 - Phibro Animal Health Corp. v. Nat'l Union Fire Ins. Co. of Pittsburgh, 446 N.J. Super. 419, 438, 142 A.3d 761, 772 (App. Div. 2016)

Business Risk Exclusions

- Your Work
- Your Product
- Impaired Property
- Sistership



Your Work

- ❑ Excludes coverage for
 - On-going: “property damage” to “that particular part of any property that must be restored, repaired or replaced because ‘your work’ was incorrectly performed on it.”
 - Completed: “‘property damage’ to ‘your work’ arising out of it or any part of it.”
- ❑ Eliminates coverage to the insured’s faulty work but not for damage to third-party property that results from the insured’s faulty work
 - Subcontractor exception
- ❑ Not for product claims

Your Product

- ❑ Excludes property damage to “your product arising out of it or any part of it.”
- ❑ Does not remove coverage for damage to other property, including damage to other of the insured’s products
- ❑ Your Product – broadly defined
- ❑ Incorporation Issues
 - If so incorporated into larger product that it cannot be separated, is it your product?
- ❑ Altered Issues
 - Has the nature of the product changed?

Example 2



- ❑ The insured manufactured gaskets that were incorporated into Zenith televisions.
- ❑ Several Zenith television sets caught on fire and damaged owners' homes.
- ❑ Zenith determined that the gaskets were defective and caused the fires.
- ❑ Zenith repaired as many televisions sets containing the insured's gaskets as possible, incurring millions of dollars in costs.
- ❑ Zenith brought suit against the insured to recover the repair and replacement costs, and the insured settled the claim for \$3 million.
- ❑ The insured's carrier, Steadfast, refused to pay the amount of the settlement under the "your product" exclusion.

Example 2 (cont.)

- ❑ Insured subsequently filed a declaratory judgment action against Steadfast.
- ❑ Steadfast contended that the repairs were made to the defective gaskets themselves, and therefore all of those costs were barred by the “your product” exclusion.
- ❑ The court disagreed, concluding that the disparity between the costs of actual damage to homes and furnishings and the comparatively miniscule costs for gasket repair made it “both fair and efficient to classify the repaired/replaced product as the Zenith televisions,” rather than the insured’s defective gasket. As such, the “Your Product” exclusion did not apply.
 - *Parker Hannifin v. Steadfast Insurance Company*, 445 F. Supp. 2d 827 (N.D. Ohio 2006)

Impaired Property

- ❑ Excludes coverage for:
 - Loss of use of property that is not physically injured arising out of a defect in the insured's product or work, or a delay or failure by the insured to perform in accordance with the terms of a contract.
- ❑ "Impaired property" defined as property that can be restored to use by repairing, replacing, adjusting or removing the insured's product or work.



Impaired Property

- ❑ The exclusion only applies when the third-party property can be restored to use by the repair or replacement of the insured's product
- ❑ If the third-party property was damaged or cannot be restored to use simply by repairing or replacing the insured's product, this exclusion does not preclude coverage
- ❑ Sudden and Accidental Exception
 - for any loss of use caused by a sudden accident after the insured's product is put to its intended use.
 - Many courts have determined that the phrase includes a temporal aspect – the injury must occur at once.

Example 3

- ❑ Insured sold defective concrete mix component to a contractor that used it to build a retaining wall.
- ❑ Wall began to fail. The wall contained both defective concrete and correctly comprised concrete, with the result that the entire retaining wall—both the part that was correct and the part that was defective, had to be removed.
- ❑ Owner sued contractor and insured, concrete mix manufacturer, for costs to repair and replace the wall.
- ❑ Does insured/concrete manufacturer's insurer have to pay for the removal and replacement of the entire wall?



Example 3 (Cont.)

- ❑ The court held that because it was impossible to remove the defective concrete without disturbing the rest of the structure, the incorporation of the defective concrete into the wall constituted property damage for which there was coverage.
- ❑ “Moraine is not seeking to recover for the defective concrete, but is seeking to recover the expenses of removing the wall, which became defective in its entirety by the incorporation therein of Moraine’s defective cement.”
 - *Moraine Materials Co., Inc. v. The Ohio Casualty Ins. Co.*, 1979 WL 208510 (Ohio App. Dec. 12, 1979)

Example 4

- ❑ Insured manufactured parts for boilers, including a part known as the “pedestal.”
- ❑ Pedestal was welded to the top of the boiler and served as the main rear hinge for the rear boiler doors.
- ❑ Customers complained and the insured replaced the pedestals and repaired other damage associated with the failure of the pedestals.
- ❑ Customers had loss of use of boilers during repairs.
- ❑ Insured seeks coverage for the cost of the repairs and loss of use.



Example 4 (Cont.)

- ❑ Held that the impaired property exclusion precluded coverage for
 - Damage to pedestals
 - Costs of inspecting the potentially defective pedestals
 - Damages to the boiler or its parts directly caused by the repair of the pedestals
- ❑ But business risk exclusions did not preclude coverage for property damage to the boilers caused by the pedestal failure but unrelated to the pedestal repair. - where repair and replacement of defective pedestals could not restore boilers to use, the “impaired property” exclusion did not apply.
 - *Gentry Machine Works, Inc. v. Harleysville Mut. Ins. Co.*, 621 F.Supp.2d 1288 (M.D. Ga. 2008)



Example 1 (revisited)

- ❑ Stunted chickens: Can they be restored to use with more time?
- ❑ Court found impaired property exclusion did not apply
 - “We conclude the most sensible reading of the phrase ‘restored to use’ within the impaired property exclusion takes into account the cost and commercial feasibility of restoration.”
 - Phibro Animal Health Corp. v. Nat'l Union Fire Ins. Co. of Pittsburgh, 446 N.J. Super. 419, 447, 142 A.3d 761, 777 (App. Div. 2016)

Rip and Tear Costs

Insurer

- ❑ Damage during the repair process is a foreseeable consequence of defective products, which is not property damage as defined by the policy.

Policyholder

- ❑ Coverage for the removal of non-defective work/products is necessary and unintentional in order to replace defective product/work.



Example 4 (Cont.)

❑ No coverage for Rip and Tear:

The Gentry Court held that physical damage to parts connected to a defective product — that is, parts that must be destroyed or damaged in the replacement process — are treated like the defective product itself and not covered.

- Ohio: *Bundy Tubing Co. v. Royal Indem. Co.*, 298 F.2d 151 (6th Cir. 1962).

U.S. Metals, Inc. v. Liberty Mutual Group, Inc.

- ❑ U.S. Metals agreed to manufacture and sell flanges to Exxon.
- ❑ The flanges were welded to pipes by a subcontractor. Once welded, the flange/pipe were attached to two new NRD (nonroad diesel project) facilities owned by Exxon.
- ❑ During pre-use testing, Exxon discovered a leak in one of the flanges.
- ❑ U.S. Metals had subcontracted the project to Maass Flange Corporation.
- ❑ The flanges were improperly manufactured against industry standards.
- ❑ Exxon wanted to replace all flanges with new ones from a different manufacturer.

U.S. Metals, Inc. v. Liberty Mutual Group, Inc.

- ❑ The two new Exxon refineries were shut down for several weeks while repairs were made.
- ❑ Exxon's corporate representative testified that the leaks were discovered at the testing stage of the new refineries and the facilities were not yet operational.
- ❑ Exxon claimed damages in excess of \$23 million.

U.S. Metals, Inc. v. Liberty Mutual Group, Inc.

□ Holding:

- Physical Injury is not ambiguous
- Installation of defective flanges into larger system did not cause physical injury.
- Insurer must cover costs to replace third-party property damaged during rip and tear.

Sistership



- ❑ Excludes coverage for
 - damages claimed for any loss, cost or expense incurred by you or others for the loss of use, withdrawal, recall, inspection, repair, replacement, adjustment, removal or disposal of: (1) Your Product; (2) Your Work; or (3) Impaired Property; if such product, work or property is withdrawn or recalled from the market or from use by any person or organization because of a known or suspect defect, deficiency, inadequacy or dangerous condition in it.
- ❑ This exclusion precludes coverage for the withdrawal of products that have not yet failed.

Incorporation Doctrine/Integrated System

- ❑ Coverage is only afforded when that integrated system causes physical injury to another tangible product.
- ❑ Exception to this general rule: if the defective ingredient or component is hazardous, then there may be physical injury to tangible property.

Baby Formula

- ❑ No exception applied: “while the nonconforming NFDM [was] undoubtedly unsafe for consumption by children with egg allergies...egg is perfectly safe.”



Example 5

- ❑ In Shade Foods, the insured sold chopped almonds to General Mills that used the almonds to make nut clusters for its cereal product.
- ❑ General Mills advised Shade Foods that it found wood splinters in the nuts.
- ❑ General Mills then shut down production and recalled the cereal.



Example 5 (Cont.)



- ❑ The Shade Foods Court found third party property damage holding that “[w]hile the distinction may sometimes be a fine one to draw, we see no difficulty in finding property damage where a potentially injurious material in a product causes loss to other products into which it is incorporated.”
- ❑ Based on the irreversible incorporation of the nuts into the nut clusters, the court held that “the wood splinters in the diced roasted almonds caused property damage to the nut clusters and cereal products in which the almonds were incorporated.”
 - *Shade Foods, Inc. v. Innovative Products Sales & Marketing, Inc.*, 78 Cal. App. 4th 847 (First Dist. 2000).
 - *But see Wisconsin Pharmacal Co. LLC v. Nebraska Cultures of California Inc. et al.; Scottsdale Insurance Company v. Spring Hill Jersey Cheese, Inc.*, Case No. 17-cv-03-0209

Example 6



- ❑ The insured, Sokol, was a food products manufacturer that supplied sealed packets of peanut butter to its customer, Continental Mills, for inclusion in boxes of Continental's cookie mix.
- ❑ After the packets were sealed into the boxes and shipped to retailers, the peanut butter was found to be rancid.
- ❑ Continental retrieved the boxes, replaced the peanut butter with packets from a different supplier and reshipped the mixes. Continental sought payment of approximately \$75,000 from Sokol.

Example 6 (Cont.)

- ❑ The court found that there was no third party property damage as the rancid peanut butter was contained in separate packets that did not affect the other food products in the mix boxes.
- ❑ The appellate court rejected Sokol's argument that Continental's need to open the boxes constituted third party property damage and further rejected the argument that Continental suffered a loss of use of its mixes by the delay in getting the cookie mix to market.
 - *Sokol and Company v. Atlantic Mutual Insurance Company*, 430 F.3d 417 (7th Cir. 2005)



Allegations in Complaint

- ❑ Coverage is highly dependent upon allegations:
 - If underlying complaint merely alleged failure to comply with contractual obligations and implied warranties resulting in monetary damages, is there coverage?
- ❑ The issue is not whether the cause of action is one for contract or tort but whether the damages may be characterized as contractual in nature or whether they are consequential property damage.

Conclusion

- ❑ Important Factors to Determine Coverage
 - Jurisdiction
 - Consequential Damages
 - Facts, Facts, Facts

