# AN UPDATE ON RECENT INSURANCE COVERAGE DECISIONS AND THEIR IMPACT ON THE CONSTRUCTION INDUSTRY:

## *THE POLICYHOLDERS' PERSPECTIVE*

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## I. *U.S. Metals, Inc. v. Liberty Mutual Group, Inc.*, No. 13-20433, 2014 WL 4652892 (5th Cir. Sept. 19, 2014)

Fresh off the heels of the Supreme Court issuing its decision on certified questions in *Ewing*, the U.S. Fifth Circuit Court of Appeals passed another case to the Supreme Court for review. *See U.S. Metals, Inc. v. Liberty Mutual Group, Inc.*, No. 13-20433, 2014 WL 4652892 (5th Cir. Sept. 19, 2014). The court's certified questions address two standard CGL exclusions—the "your product" exclusion and the "impaired property" exclusion.

### A. Background

Exxon Mobil contracted with U.S. Metals to manufacture and sell to Exxon weld-neck flanges for refineries in Texas. *Id.* at *1. The flanges were "irreversibly incorporated" into certain facilities by welding and bolting the flanges into unit pipes that were insulated and buttoned up to "nonroad diesel" ("NRD") equipment. Exxon discovered a leak in one of the flanges during testing. Its subsequent investigation revealed that the flanges had been improperly manufactured. *Id.* As a result of the leaks, Exxon ordered new flanges from a different manufacturer and replaced all the flanges from U.S. Metals. In addition to the work that had to be done to remove and replace the flanges, the refineries had to be shut down for a period of time. *Id.*

Exxon filed suit against U.S. Metals, but Liberty Mutual had disclaimed coverage for the matter. *Id.* at *2. Thereafter, U.S. Metals settled with Exxon for nearly $6.5 million and then sought indemnification from Liberty Mutual, which again denied coverage. *Id.* Liberty Mutual's denial was premised on the "your product" and "impaired property" exclusions. *Id.* In the trial court, Liberty Mutual prevailed on summary judgment. U.S. Metals filed a timely appeal.

### B. Certified Questions to the Supreme Court of Texas

According to the court, the issues before it turned on two questions of law that have not been directly addressed by the Supreme Court: (1) whether the terms "physical injury" and "replacement" found in the common "your product" and "impaired property" exclusions are ambiguous; and (2) if not, what do these terms mean pursuant to Texas law? *Id.* at *3. While the exclusions at issue are commonly found in CGL policies in Texas, the Fifth Circuit noted that the Supreme Court had not issued any decisions interpreting the language of the exclusions. *Id.* However, with regard to physical injury," the Fourteenth District Court of Appeals in Houston interpreting the meaning of that phrase in a similar "your property" exclusion. Liberty claims that the holding in that case means that the incorporation of a defective product into other property is not, standing alone, "physical injury." *Id.* at *4 (citing *Lennar Corp. v. Great Am. Ins. Co.*, 200 S.W.3d 651 (Tex. App.—Houston [14th Dist.] 2006, pet. denied)). But that court did not address whether damage to other integrated components would constitute "property damage." *Id.* And, on the other side of the line, the U.S. Seventh Circuit Court of Appeals held more than two decades ago that "physical injury" occurs at the moment of incorporation into

another product. *Id.* (citing *Eljer Mfg., Inc. v. Liberty Mut. Ins. Co.*, 972 F.2d 805, 807–14 (7th Cir. 1992) (applying Illinois law)[1]).

With regard to "replacement," a decision from the Southern District of Texas found that the term included the cost of tearing down other injured components even if the other components were "physically injured" on installation of the defective product. *Id.* (citing *Bldg. Specialties, Inc. v. Liberty Mut. Fire Ins. Co.*, 712 F. Supp. 2d 628, 641 (S.D. Tex. 2010)). And, in a prior Fifth Circuit decision, the court found the "impaired property" exclusion did not apply where the asphalt parking lot at issue could not be restored to use by "the repair, replacement, adjustment or removal" of the insured's defective excavation, backfilling and compacting work. *Id.* (citing *Fed. Mut. Ins. Co. v. Grapevine Excavation, Inc.*, 197 F.3d 720, 722 (5th Cir. 2000)). In Georgia, a federal district court found that damage to component parts during the repair and/or replacement of the faulty parts was excluded under the "impaired property" exclusion. *Id.* at *5 (citing *Gentry Mach. Works Inc. v. Harleysville Mut. Ins. Co.*, 621 F. Supp. 2d 1288, 1298 (M.D. Ga. 2008)).

Nevertheless, because none of the case law discussed included controlling Supreme Court case law, the Fifth Circuit certified the following four questions to the Court:

1. In the "your product" and "impaired property" exclusions, are the terms "physical injury" and/or "replacement" ambiguous?

2. If yes as to either, are the aforementioned interpretations offered by the insured reasonable and thus, must be applied pursuant to Texas law?

3. If the above question 1 is answered in the negative as to "physical injury," does "physical injury" occur to the third party's product that is irreversibly attached to the insured's product at the moment of incorporation of the insured's defective product or does "physical injury" only occur to the third party's product when there is an alteration in the color, shape, or appearance of the third party's product due to the insured's defective product that is irreversibly attached?

4. If the above question 1 is answered in the negative as to "replacement," does "replacement" of the insured's defective product irreversibly attached to a third party's product include the removal or destruction of the third party's product?

*Id.*

**Commentary:**

The forthcoming decision from the Supreme Court of Texas in *U.S. Metals* could prove to be a monumental one. For years, the common belief has been that Texas did not follow the

[1] Notably, the Illinois Supreme Court later criticized the Seventh Circuit's *Erie* guess. *See Travelers Ins. Co. v. Eljer Mfg., Inc.*, 757 N.E.2d 481 (Ill. 2001).

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