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

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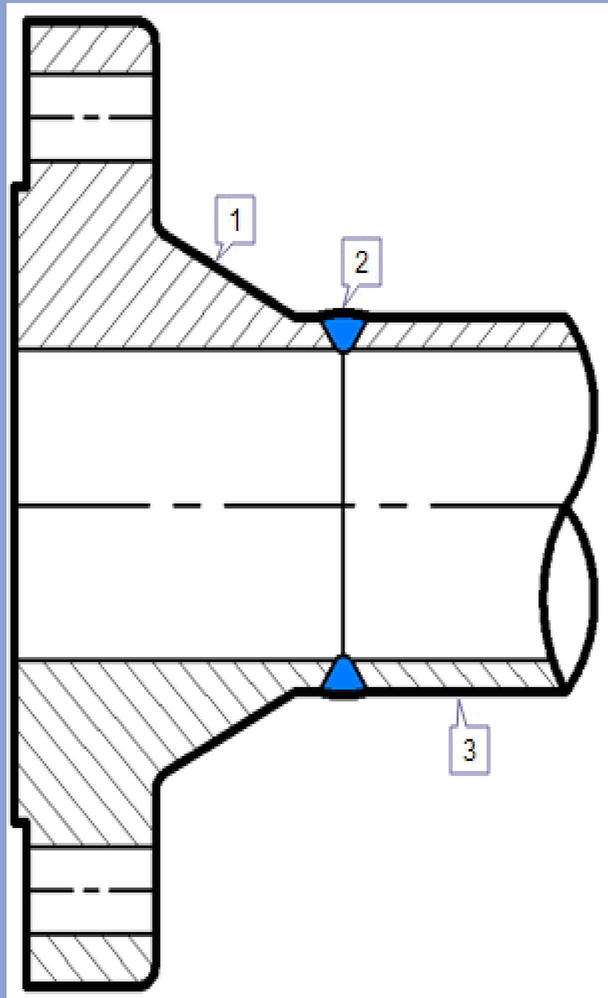
# THREE TOPICS

1) “PHYSICAL INJURY”
2) “IMPAIRED PROPERTY” EXCLUSION
3) “RIP AND TEAR” COSTS

# FACTS

- U.S. Metals, Inc. sold ExxonMobil about 350 weld-neck flanges to be installed into diesel processing units at two Exxon refineries.
- These units operate under extremely high heat.
- The flanges were welded to piping, then both were covered with high-temp coating and insulation.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# FACTS

- Several flanges leaked in post-installation testing.
- Extensive investigation revealed that the flanges did not meet industry standards. ExxonMobil decided to replace them to avoid the risk of fire and explosion.
- For each flange, the replacement process involved:

  1) **stripping** the coating and insulation (destroyed in the process),
  2) **cutting** the flange out of the pipe,
  3) **removing** the gaskets (destroyed in the process),
  4) **grinding** the pipe surfaces smooth for re-welding,
  5) **replacing** the flange and gaskets,
  6) **welding** the new flange to the pipes, and
  7) **replacing** the temperature coating and insulation.

- This process delayed operation of the diesel units for several weeks.

# FACTS

- ExxonMobil **sued** U.S. Metals for:
  a) $6,345,824 for the cost of replacing the flanges and
  b) $16,656,000 for the lost use of the units during the replacement process.
- U.S. Metals **settled** with ExxonMobil for $2.2 million
- ExxonMobil **claimed indemnification** from its CGL carrier, Liberty Mutual.
- Liberty Mutual **denied coverage**.

# FACTS

- U.S. Metals **sued** Liberty Mutual in federal court for **defense and indemnity** under the policy.
- The court granted **summary judgment** for Liberty Mutual.
- On **appeal**, the Fifth Circuit certified to the Texas Supreme Court. The Texas Supreme Court's opinion hits on three major topics: physical injury, impaired property, and rip and tear damages.

# PHYSICAL INJURY

- The parties disputed whether installation of the faulty flanges ***physically injured*** the diesel units within the meaning of the CGL policy.

- The policy defines "property damage" in part as:

  a. ***Physical injury*** to tangible property, including all resulting loss of use of that property. All such loss of use shall be deemed to occur at the time of the physical injury that caused it.

# INCORPORATION THEORY

- This theory was propounded by US Metals, but rejected by the Court.
- A thing whose use or function is diminished by the incorporation of a faulty component can fairly be said to be injured.
- The installation of the leaky flanges certainly injured the diesel units by increasing the risk of danger from their operation and thus reducing their value.
- But if that increased risk amounted to *physical* injury within the meaning of the CGL policy, then it is difficult to imagine a non-physical injury.

# OTHER STATE HIGH COURTS

- Twelve state high courts have considered the incorporation theory.
- Five have **expressly rejected** the theory. *See U.S. Fire Ins. Co. v. J.S.U.B., Inc.*, 979 So. 2d 871, 890 (Fla. 2007); *Travelers Indem. Co. of Am. v. Moore & Assocs., Inc.*, 216 S.W.3d 302, 309-310 (Tenn. 2007); *United Nat'l Ins. Co. v. Frontier Ins. Co.*, 99 P.3d 1153, 1158 (Nev. 2004); *Wyo. Sawmills, Inc. v. Transp. Ins. Co.*, 578 P.2d 1253, 1256 (Or. 1978); *Taylor Morrison Servs., Inc. v. HDI-Gerling Am. Ins. Co.*, 746 S.E.2d 587, 591 n.10 (Ga. 2013).
- Five have **impliedly rejected** the theory. *See Capstone Bldg. Corp v. Am. Motorists Ins. Co.*, 67 A.3d 961, 980-982 (Conn. 2013); *Crossmann Cmtys. Of N.C. Inc. v. Harleysville Mut. Ins. Co.*, 717 S.E.2d 589, 594 (S.C. 2011); *Concord Gen. Mut. Ins. Co. v. Green & Co. Bldg. & Dev. Corp.*, 8 A.3d 24, 26-28 (N.H. 2010); *Vogel v. Russo*, 613 N.W.2d 177, 183-184 (Wis. 2000) (abrogated on other grounds); *Mut. of Enumclaw Ins. Co. v. T & G Constr., Inc.*, 199 P.3d 376, 384 (Wash. 2008).
- Two state high courts have **followed** the incorporation theory. *See Helm v. Bd. of Cty. Comm'rs,* 989 P.2d 1273, 1276 (Wyo. 1999); *Swank Enters., Inc. v. All Purpose Servs., Ltd.*, 154 P.3d 52, 56 (Mont. 2007).

# REJECTION OF INCORPORATION THEORY

- "We agree with most courts to have considered the matter that the best reading of the standard-form CGL policy text is that physical injury requires tangible, manifest harm and does not result merely upon the installation of a defective component in a product or system."
- The Court's rejection of the incorporation theory is consistent with its other interpretations of CGL policies.
  1) "[F]aulty workmanship that merely diminishes the value of the home without causing physical injury or loss of use does not involve 'property damage.'" *Lamar Homes, Inc. v. Mid-continent Cas. Co.*, 242 S.W.3d 1, 8-10 (Tex. 2007).

  2) For purposes of a duty to defend under an occurrence-based policy period, damage due to faulty workmanship "occurs" not at the time the damage manifests (when it is discovered or discoverable) nor when the plaintiff is exposed to the agent. Rather, "[o]ccurred means when *damage* occurred, not when *discovery* occurred." *Don's Bldg. Supply, Inc. v. OneBeacon Ins. Co.*, 267 S.W.3d 20, 24-30 (Tex. 2008).

# PERVERSE RESULT

- Had ExxonMobil been negligent or reckless by not testing the flanges and an explosion had resulted, U.S. Metals would be covered for damages to persons and property.
- But because ExxonMobil was careful and cautious, U.S. Metals is not entitled to coverage for the costs of remedying the installation of the faulty flanges.
- Nevertheless, the Court thought the text of the policy was clear and concluded that ExxonMobil's diesel units were not physically injured merely by the installation of U.S. Metals' faulty flanges.

# NO PHYSICAL INJURY UNTIL EXPLOSION

- In *Eljer Manufacturing, Inc. v. Liberty Mutual Insurance Co.* (*Eljer I*), the Seventh Circuit stated:

“The central meaning of [physical injury] as it is used in everyday English . . . is of **a harmful change in appearance, shape, composition, or some other physical dimension** of the "injured" person or thing. If water leaks from a pipe and discolors a carpet or rots a beam, that is physical injury, perhaps beginning with the very earliest sign of rot—the initial contamination . . . . The ticking time bomb, in contrast, does not injure the structure in which it is placed, in the sense of altering the structure in a harmful, or for that matter in any, way—until it explodes.”

# PHYSICAL INJURY AFTER EXPLOSION

- INSERT MOVIE CLIP

# BUT WAIT . . . .

- The Court found the diesel units ***were*** physically injured during the replacement process.

- Remember: the faulty flanges had to be **cut out**, pipe edges **resurfaced**, and new flanges **welded** in. The original welds, coating, insulation, and gaskets were **destroyed** in the process and had to be replaced.

- The fix **necessitated injury to tangible property**, and the injury was **unquestionably physical**, so the repair costs and damages for the downtime were **"property damages"** covered by the policy-- **unless Exclusion M applies**.

# EXCLUSION M

- Excludes coverage for damages to ***impaired property***—defined as property that could be **"restored to use by the . . . replacement"** of the insured’s product or work.
- Here, the insured’s product was the flanges. Thus, there is no coverage for damages to the units if they could be “restored to use” by replacement of the flanges.
- U.S. Metals concedes that if the flanges had been ***screwed*** onto the pipes, the replacement process would have been simple, restoring the diesel units to use, and making them "impaired property".
- But U.S. Metals argues that because the flanges were ***welded*** in, restoration was much more involved and therefore the diesel units were not "impaired property" and Exclusion M does not apply.

# THE COURT DISAGREED

- The **policy definition** of "impaired property" **does not restrict** *how* the defective product must be replaced.

- **U.S. Metals' argument requires limiting the definition** to property "restored to use by the . . . replacement of [the flanges]" *without affecting or altering the property in the process*.

- “In U.S. Metals' view, the diesel units could not be restored to use by replacement of the flanges, not only because they had to be cut out and welded back in, but because of the wholly incidental replacement of insulation and gaskets. Coverage does not depend on such minor details of the replacement process but rather on its efficacy in restoring property to use.”

- The diesel units **were restored to use** by replacing the flanges and were therefore impaired property to which **Exclusion M applies**.

# WHAT WE (THINK WE) KNOW

1) **“Physical injury”** requires tangible, manifest harm and does not result merely upon the installation of a defective component in a product or system.

2) **Exclusion M** precludes coverage for the loss of use of the diesel units because they were restored to use by replacing the flanges.

3) **Exclusion K** precludes coverage for damage to the flanges themselves, and U.S. Metals did not seek coverage for those damages.

# BUT WAIT (AGAIN) . . . .

- “But the **insulation and gaskets** destroyed in the process were not restored to use; they were replaced. They were therefore **not impaired property** to which Exclusion M applied, and the cost of replacing them was therefore covered by the policy.”

# RIP AND TEAR

- The insuring agreement obligates Liberty Mutual to “pay those sums that [U.S. Metals] becomes legally obligated to pay as damages ***because of*** . . . ***‘property damage’ to which this insurance applies***.”

- Here, the “rip and tear” expenses for the insulation and gaskets were “***because of” property damage*** to the diesel units/flanges.

- ***BUT***, these expenses were not “damages because of . . . ‘property damage’ ***to which this insurance applies.”***

# TO WHICH THIS INSURANCE APPLIES

- The CGL insuring agreement's language "***to which this insurance applies***" means that the "property damage" must be covered before the consequential damages flowing from such "property damage" can be covered. *See, e.g.*, *Hartford Acc. & Indem. Co. v. Pac. Mut. Life Ins. Co.*, 861 F.2d 250, 255 (10th Cir. 1988) ("Since the insured's products and installation are not property damage to which the insurance applies, any consequential damages caused by such products and installation are not covered."); *American Home Assurance Co. v. Libbey-Owens-Ford Co.*, 786 F.2d 22, 24-25 (1st Cir. 1986) (stating a CGL policy "would cover only consequential damages resulting from 'property damage to which this insurance applies'").

# CONSEQUENTIALS OF COVERED PROPERTY DAMAGE

- **If There Is Covered Property Damage, Rip And Tear Expenses Are Covered.**
- In *Lennar Corp. v. Markel American*, 413 S.W.3d 750 (Tex. 2013), a homebuilder made a claim for the cost to repair its homes that had been damaged because of EIFS siding that had been installed on the homes. *Id.* at 751.
- There, the Court awarded the costs Lennar incurred to determine the areas of the homes that had water damage were covered. *Id.* The Court noted the importance that Lennar was seeking these "because of" damages for only houses that suffered covered 'property damage,' by stating, 'We are not confronted with a situation in which the existence of damage was doubtful.' Markel concedes that each of the 465 homes for which Lennar sought to recover remediation costs was actually damaged."
- Indeed, Lennar removed forty-eight homes that had not incurred covered property damage from its proof at trial.

# THE PROPERTY DAMAGE HERE WAS EXCLUDED

- Excluded "property damage":
  a) **Damage to the diesel units** (i.e., their loss of use)-- by the "impaired property" exclusion (Ex. M)
  b) **Damage to the flanges--** by "your product" exclusion (Ex. K)

- Thus, the "rip and tear" expenses are damages **because of "property damage"** to which this insurance ***does not apply***.

# WHAT THIS MEANS GOING FORWARD

- ***If There is No Covered Property Damage, Rip and Tear Expenses Covered?***
- For example, what if the insured is a concrete subcontractor who provides bad concrete that results in the spalling of a home's foundation and no damage to other property. Subsequent ripping up/destroying the bad concrete is necessary and causes damage to other items (e.g., rebar, plumbing, electrical). What now?
- The "your product" and/or "your work" exclusions (Exclusion K and L) would likely preclude coverage to the insured for the costs to repair/replace the insured's concrete.
- But how about the expenses incurred getting to and removing the uncovered "property damage," such as the destroyed rebar?
- These "rip and tear" expenses should not be permitted to create coverage when coverage for repairing the uncovered "property damage" would not otherwise exist. The insuring agreement grants coverage for "because of" damages, but only if there is "'property damage' ***to which this insurance applies***."