Rip and Tear Coverage after U. S. Metals

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FACTS

- U.S. Metals, Inc. sold ExxonMobil approximately 350 stainless steel, weld-neck flanges for use in constructing non-road diesel units at its refineries.
- The units remove sulfur from diesel fuel and operate under extremely high temperatures.
- After the flanges were welded to the piping, they were covered with a special high temperature coating and insulation.
- In post-installation testing, several flanges leaked. Further investigation revealed that the flanges did not meet industry standards.

FACTS

- ExxonMobil decided it was necessary to replace the flanges to avoid the risk of fire and explosion.
- For each flange, this process involved stripping the temperature coating and insulation (which were destroyed in the process), cutting the flange out of the pipe, removing the gaskets (which were also destroyed in the process), grinding the pipe surfaces smooth for re-welding, replacing the flange and gaskets, welding the new flange to the pipes, and replacing the temperature coating and insulation.
- The replacement process delayed operation of the diesel units at both refineries for several weeks.

FACTS

- ExxonMobil sued U.S. Metals for $6,345,824 as the cost of replacing the flanges and $16,656,000 as damages for the lost use of the diesel units during the process.
- U.S. Metals settled with ExxonMobil for $2.2 million and then sought indemnification from its CGL carrier, Liberty Mutual.
- Liberty Mutual denied coverage.

FACTS

- U.S. Metals sued in federal district court to determine its right to a 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 four questions that the Court narrowed down to two issues.

TWO PRIMARY ISSUES

- (1) “Did the mere installation of the faulty flanges physically injure the diesel units when the only harm at that point was the risk of leaks? Or put more generally: is property physically injured simply by the incorporation of a faulty component with no tangible manifestation of injury?”
- (2) “Is property restored to use by replacing a faulty component when the property must be altered, damaged, and repaired in the process?”

WHAT NOT CERTIFIED

- What was not certified was whether rip and tear costs to replace a defective product or defective workmanship would be considered covered under the policy

PHYSICAL INJURY

- The parties disputed whether the 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

- 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. ofN.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) Faulty workmanship can be the basis of an "occurrence," but "faulty workmanship that merely diminishes the value of the home without causing physical injury or loss of use does not involve 'property damage.'"

  (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."

PERVERSE RESULT

- Had ExxonMobil been negligent or reckless by not testing the flanges and an explosion had resulted, U.S. Metals would not be denied coverage for the damages to persons and property for want of physical injury. But because ExxonMobil was careful and cautious, U.S. Metals is not entitled to indemnity 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."

BUT WAIT . . . .

- The Court found the units *were* physically injured in the process of replacing the faulty flanges.
- Because the flanges were welded to pipes rather than being screwed on, 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.
- Thus, the repair costs and damages for the downtime were "property damages" covered by the policy unless Exclusion M applies.

EXCLUSION M

- Exclusion M denies coverage for damages to impaired property—defined by the policy as property that could be "restored to use by the . . . replacement" of the faulty flanges.
- U.S. Metals concedes that if the flanges had been screwed onto the pipes, removal and replacement would have been a simple matter, readily restoring the diesel units to use, and making them "impaired property".
- But because the flanges were welded in, U.S. Metals argues, restoring the diesel units to use involved much more than simply removing and replacing the flanges alone, 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 is to 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

- “Physical injury” requires tangible, manifest harm and does not result merely upon the installation of a defective component in a product or system.
- Exclusion M precluded coverage for the loss of use of the diesel units because they were restored to use by replacing the flanges.
- Exclusion K precluded coverage for damages to the flanges themselves, and U.S. Metals did not seek indemnity 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."
- The Court concludes these "rip and tear" costs are covered because these items were physically injured (i.e., "property damage").

RIP AND TEAR

- However, the "rip and tear" expenses for the insulation and gaskets appeared to be consequential damages (i.e., "because of") property damage to the diesel units.
- ***Notably***, these expenses would not be "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'").

THE PROPERTY DAMAGE WAS EXCLUDED HERE

- Here, the Liberty Mutual policy excludes the "property damage" to the diesel units (i.e., their loss of use) by the "impaired property" exclusion (i.e., Exclusion M).
- The policy also excludes the "property damage" to the flanges as a result of the "your product" exclusion (i.e., Exclusion 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 Covered Property Damage, Rip And Tear Expenses Are Almost Certainly 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.

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 would appear to create coverage when there is no coverage before the rip and tear.

OTHER STATES

- Desert Mountain Prop. Ltd Partnership v. Liberty Mutual Fire Ins. Co., 236 P.3d 421 (Ariz.App.2010, aff'd 250 P.3d 196 (Ariz. 2011)
- H.E.Davis & Sones, Inc. v. North Pacific Ins. Co., 248 F.Supp.2d 1079 (D. Utah 2002)
- Woodfin Equities Corp. v. Hartford Mut. Ins. Co., 678 A.2d 116 (Md. App. Ct. 1996)

CURRENT APPLICATION

- **General Contractor**
- -2294 Endorsement
- -No 2294 Endorsement
- **Sub-Contractor**
- -2294 Endorsement
- -No 2294 Endorsement

CURRENT APPLICATION

- Ongoing Operations
- J(5)
- J(6)

ISSUES NOT ADDRESSED

- When Does Property Damage for Rip and Tear Occur?
- IS Rip and Tear an Occurrence?
- IS Rip and Tear a Fortuitous Event?
- Application of Exclusion (a)

ENDORSEMENTS AVAILABLE

THIS ENDORSEMENT CHANGES THE POLICY. PLEASE READ IT CAREFULLY.
EXCLUSION — RIP AND TEAR

This endorsement modifies insurance provided under the following: COMMERCIAL GENERAL LIABILITY COVERAGE PART

The following is added to SECTION I — COVERAGES, COVERAGE A BODILY INJURY AND PROPERTY DAMAGE LIABILITY, Paragraph 2. Exclusions:

Rip And Tear
Damages arising out of:

(1) Any expenses incurred in removing concrete or concrete products from any structure or building due to defective concrete or for improperly mixed, manufactured, poured, formed, cured, or installed concrete;

(2) Any expenses for replacing forms, reinforcements, piping and wiring that are destroyed during the course of removing defective concrete products; or

(3) Any expenses for returning the structure or building to the condition that existed prior to the installation of concrete products.

All other terms and conditions under the policy remain unchanged.

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ENDORSEMENTS AVAILABLE

THIS ENDORSEMENT CHANGES THE POLICY. PLEASE READ IT CAREFULLY.

Rip And Tear Exclusion - Concrete Products

This endorsement modifies insurance under the following:

Commercial Umbrella Policy
Commercial Follow Form Policy

This insurance does not apply to any liability for property damage for "ripping and tearing expenses" and "restoration expenses."

The following definitions apply:

"Ripping and Tearing expenses" shall mean the actual expenses incidental to the intentional destruction and removal of "concrete products" which are found to be "defective."

"Restoration expenses" shall mean such additional expenses paid as are necessary to place the structure in the same condition existing at the time such "concrete products" were determined to be defective; but in no event shall they include the cost of the "concrete products" themselves or labor incidental to their replacement.

"Concrete products" shall mean poured concrete, concrete block and mortar and prestressed structural concrete.

"Defective" shall mean "concrete products" which, upon testing by an accredited independent testing agency, do not meet the contractual specifications relating to compressive strength required for the specific construction in which such materials were incorporated.

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