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PRODUCT LIABILITY & TOXIC TORTS

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No Coverage? Don't Be So Sure

New Jersey policyholders should explore the full extent of their coverage before accepting an insurance company's rejection of product liability claims

The cornerstone of any product manufacturer's insurance program is the Comprehensive or Commercial General Liability insurance policy. CGL insurance policies are designed to protect the policyholder against a variety of liabilities to third parties, including liability for bodily injury and property damage arising out of products manufactured by the policyholder. The standard form CGL insurance policy also contains so-called "business risk" exclusions that may affect insurance coverage for certain product liability claims. The insurance industry argues that these exclusions bar insurance coverage for liabilities arising out of poor work or product performance — alleged "ordinary costs of doing business." While this argument has been adopted in some contexts, in at least one important context, it has been rejected in New Jersey. Under New Jersey law, liabilities arising from the incorporation of a policyholder's defective product into a third-party's product potentially are covered by CGL insurance policies.

New Jersey courts have held that a policyholder's defective product may become so intertwined with or "incorporated" into a final defective product (which is or contains third-party property) as to render the final product "physically injured" and the "business risk" exclusions inapplicable. The principle of law allowing insurance coverage in such instances is embodied in the New Jersey Appellate Division's decision in *Newark Ins. Co. v. Acupac Packaging, Inc.*, 328 N.J. Super. 385, 392 (App. Div. 2000), and is known as the "incorporation doctrine." In light of *Acupac*, New Jersey policyholders are well advised to explore the full extent of their insurance coverage before accepting an insurance company's rejection of product liability claims.

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"Business Risk" Exclusions

A brief discussion of the various "business risk" exclusions and the rationale behind them is helpful in understanding the application of the "incorporation doctrine." Standard form CGL insurance policies commonly contain four "business risk" exclusions. The "own product exclusion" purports to exclude coverage for property damage to the policyholder's own product. The "work product exclusion" purports to exclude coverage for property damage to the policyholder's own work. The "impaired property" exclusion purports to exclude coverage for damage to property that is not "physically injured" but that cannot be used or is less useful because of a defect in the policyholder's product or a deficiency in its work. Finally, the "sistership exclusion" purports to exclude coverage for the recall of the policyholder's product in certain situations.

"Business risk" exclusions are used to clarify that CGL insurance policies do not, as a general matter, guarantee a policyholder's performance of contractual obligations with respect to simple economic loss. CGL insurance policies are intended, however, to protect against claims of liability for bodily injury and property damage, whether such claims arise in tort or contract. While courts generally recognize this distinction, they also are careful to protect against "business risk" exclusions from being interpreted too broadly.

> There is a critical distinction between insurance coverage for tort liability for physical damages to other persons or property, and protection from contractual liability of the insured for economic loss caused by improper workmanship. Ordinarily, the coverage is for tort liability for physical damage to others and not for contractual liability of the insured for economic loss because the product or completed work is not that for which the damaged person bargained. *Acupac*, 328 N.J. Super at 391

(citing *Weedo v. Stone-E-Brook, Inc.*, 81 N.J. 233, 240-241 (1979)).

CGL insurance policies are designed to protect the policyholder against unexpected liability. According to one court, public policy militates against insurance coverage to guarantee against economic loss regardless of the quality of workmanship. "Equally repugnant on policy grounds is the notion that the presence of insurance obviates the obligation to perform the job initially in a workmanlike manner." *Knutson Const. Co. v. St. Paul Fire and Marine Ins. Co.*, 396 N.W.2d 229, 235 (Minn. 1986) (quoting *Centex Homes Corp. v. Prestressed Sys.*, 444 So.2d 66, 66-67 (Fla. App. 1984). This rationale should not be used to deny insurance coverage for damage to third-party property, a risk clearly covered under CGL insurance policies. This premise is supported by New Jersey law. See *Weedo*, 81 N.J. at 241; *Acupac*, 328 N.J. Super. at 399-400. Insurance companies, however, continually attempt to deny insurance coverage for such liabilities as "business risks."

The "business risk" exclusion most often raised by insurance companies to deny insurance coverage for product liability claims is the "impaired property" exclusion, which is made confusing by its use of a number of defined terms. The exclusion purports to bar insurance coverage for "property damage" to "impaired property" or property that has not been physically injured. "Property damage" typically is defined as physical injury to tangible property or loss of use of tangible property that is not physically injured. "Impaired property" typically is defined as "tangible property, other than 'your product' or 'your work' that cannot be used or is less useful because: a. It incorporates 'your product' or 'your work' that is known or thought to be defective, deficient, inadequate or dangerous…if such property can be restored to use by: a. The repair, replacement, adjustment or removal of 'your product' or 'your work' … " *Acupac*, 328 N.J. Super. at 392.

By its express terms, the "impaired property" exclusion only potentially applies if the property in question has not been physically injured or is not "impaired property." Id. If the property in question has been physically injured, therefore, it is not "impaired property," and the exclusion does not apply. As a result, a crucial issue is whether, and at what point, third-party property is physically injured.

The Incorporation Doctrine

Courts have found physical injury to property where a defective product has been so intertwined or incorporated into that property that it is irreparable (literally or cost-effectively), even if the defective product has yet to fail. This is the "incorporation doctrine."

Eljer Manufacturing, Incorporated v. Liberty Mutual Insurance Company, 972 F.2d 805 (7th Cir. 1992), is the seminal case adopting the "incorporation doctrine." The policyholder in *Eljer* sold defective plumbing systems, installed in homes and apartments, which leaked and caused property damage approximately 5 percent of the time. Eljer's CGL insurance policy covered claims for "physical injury to tangible property." The central issue in *Eljer* (which did not involve the "impaired property" or other "business risk" exclusions) was "when if ever the incorporation of one product into another can be said to cause physical injury?" *Eljer*, 972 F.2d at 808.

The *Eljer* court held that "physical injury to tangible property" occurred upon installation of the plumbing systems into homes and apartments, as opposed to when the systems leaked, and granted insurance coverage under the insurance policies in effect at installation. Several courts have rejected this reasoning and declined to follow *Eljer*. See *Aetna Life & Cas. v. Patrick Industries, Inc.*, 645 N.E.2d 656 (Ind. App. 1995); *Travelers Ins. Co. v. Eljer Mfg., Inc.*, 757 N.E.2d 481 (Ill. 2001); *Wisconsin Label Corp. v. Northbrook Property & Cas. Ins. Co.*, 607 N.W.2d 276 (Wis. 2000); *National Union Fire Ins. Co. of Pittsburgh, PA. v. Terra Industries, Inc.*, 216 F.Supp.2d 899 (N.D. Iowa 2002).

The court was influenced by the fact that the plumbing systems (1) had a high expected failure rate and (2) could only be replaced by causing substantial damage to the structures in which they had been installed. This rationale is particularly relevant to the application of the "impaired property" exclusion — which expressly does not apply to claims of "physical injury." The New Jersey Appellate Division analyzed this situation in *Acupac* and adopted the reasoning of *Eljer*.

The policyholder in *Acupac* produced foil pacquettes to be filled with lotion, attached to a third party's advertising cards and then bound into magazines for an advertising campaign. Many of the pacquettes could not withstand the pressure of the binding process and exploded, damaging the cards to which they were attached. The insurance company granted insurance coverage for the loss of cards onto which the lotion actually leaked, but denied insurance coverage for (1) costs arising from the inability to use the remaining pacquettes filled with lotion, including the costs of cards and lotion that could not be used because of the concern about leakage, and (2) the cost of attaching the pacquettes to the cards.

The *Acupac* court followed the rationale of *Eljer* and held "if Acupac can establish that it was inevitable that all, or a substantial portion, of the cards would be destroyed once subjected to the binding process, those cards … were indeed damaged" as of the date of installation. *Acupac* at 400. Under that circumstance, the court found that the "impaired property" exclusion would not apply because property had been "physically damaged." In drawing these conclusions, the court noted questions of fact regarding whether (1) the expected failure rate of the pacquettes may be sufficiently high to render the product defective and "induce a rational owner to replace it before it fails" and (2) it may be more costly to remove the pacquettes from the cards than to simply reprint the cards. *Acupac*'s policyholder-friendly precedent continues to be followed by New Jersey courts. See *Aetna Casualty & Surety Co. v. Ply Gem Industries, Inc.*, 343 N.J. Super. 430 (App. Div. 2001); *GAF Corporation v. Allstate Ins. Co., et al.*, Docket No.: L-

10529-98, slip op. (N.J. Super. Ct. Law Div., January 27, 2003).

Be Aware, Be Wary, Persist

New Jersey policyholders must (1) be aware of their rights as outlined by the growing body of law following *Acupac* (i.e. the "impaired property" exclusion is inapplicable to third-party property damage); (2) be wary of insurance companies who rely upon the "impaired property" exclusion to disclaim insurance coverage for claims involving incorporated products; and (3) persist in enforcing their rights to insurance coverage for damage caused by their incorporated products. ■