

TEXAS INSURANCE LAW NEWSBRIEF

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TEXAS SUPREME COURT ANSWERS CERTIFIED QUESTIONS ADDRESSING "PHYSICAL INJURY" AND "IMPAIRED PROPERTY" EXCLUSIONS ARISING FROM DEFECTIVE PARTS INSTALLED IN REFINERY

Last Friday, the Texas Supreme Court answered controversial coverage questions certified by the Fifth Circuit. The issues in *U.S. Metals, Inc. v. Liberty Mut. Grp., Inc.*, No. 14-0753, 2015 WL 7792557 (Tex. December 4, 2015), arose out of damage caused by defective steel flanges installed in an oil refinery by an insured, which raised questions of whether certain types of resulting damage were excluded under the property-damage provisions of a commercial-general-liability policy (CGL).

The insured, U.S. Metals, Inc., sold ExxonMobil Corporation several steel flanges for Exxon to use in constructing diesel units at Exxon's refineries in Baytown, Texas and Baton Rouge, Louisiana. Exxon contracted for flanges meeting industry standards to withstand extremely high temperatures and pressures. During post-installation testing, several flanges leaked, and Exxon's investigation revealed that the flanges failed to meet industry standards. Fixing this problem required removing the flanges and surrounding materials at significant expense, which delayed operation of the diesel units for several weeks.

Exxon sued U.S. Metals for \$6,345,824, the cost to replace the flanges and \$16,656,000 in damages for the lost use of the diesel units. U.S. Metals settled with Exxon for \$2.2 million and then sought indemnification from its CGL insurer, Liberty Mutual Group, Inc.

The Liberty Policy provided coverage for "those sums that [U.S. Metals] becomes legally obligated to pay as damages because of... 'property damage' to which this insurance applies..." The Policy defined 'property damage' as "[p]hysical injury to tangible property, including all resulting loss of use of that property", and "[l]oss of use of tangible property that is not physically injured..." Two exclusions were at issue in this case: (1) Subparagraph K for "property damage" to U.S. Metals' products; and (2) Subparagraph M for "'property damage' to 'impaired property' or property that has not been physically injured, arising out of... [a] defect, deficiency, inadequacy or dangerous condition in 'your product'..." The Policy defined "impaired property" as "tangible property, other than 'your product'..., that cannot be used or is less useful because (a) it incorporates 'your product'... that is known or thought to be defective, deficient, inadequate or dangerous... if such property can be restored to use by the repair, replacement, adjustment or removal of 'your product'... or your fulfilling the terms of the contract or agreement."

The Court first noted that Exclusion K excluded damage to the flanges themselves. It then turned to the primary issues certified by the Fifth Circuit: (1) whether the mere installation of the flanges constituted "physical injury" to the diesel units when the only harm at that point was the risk of leaks, and not any actual manifestation of property damage; and (2) whether property is "restored to use" by replacing a faulty component when the property must be altered, damaged, and repaired.

The first issue turned on whether mere risk of physical damage caused by a defective component was the same as "physical injury" within the meaning of the Policy. The Court observed that even though the defective flanges leaked, Exxon replaced them before they caused any actual damage. The Court looked to how courts in several other jurisdictions have split on the issue and agreed with a majority of these courts 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 noted that this result was consistent with related Texas cases that addressed the time of damage in an occurrence-based policy. For example, in cases involving damage from faulty workmanship, previous cases held that this damage "occurs" not at the time the damage manifests or when a plaintiff is exposed to the agent that will eventually cause the damage, but rather when the actual damage occurred. Applying this logic to the present case, the Court concluded that the risk of physical damage is not the same as physical damage, even though a company may proactively incur significant expense in addressing this risk through repairs.

Despite concluding that the diesel units in this case did not suffer "physical injury" by mere installation, it noted that the units *were* damaged during the replacement process. The issue regarding this subsequent damage was whether Exclusion M applied, which excluded coverage for property "restored to use." U.S. Metals argued that this case required much more than simple restoration because the welded flanges had to be torn out, damaging surrounding property in the process. The Court disagreed, finding that the Policy's definition of "impaired property" does not depend on the manner in which defective property is replaced. The Court held that the exclusion applied to the loss of use of the diesel units because they were "impaired" by the replacement of the flanges. The Court

did find, however, that the insulation and gaskets were not restored within the meaning of the exclusion, but instead entirely replaced, and therefore held that the cost of replacing these items was covered.

Editor's Note: Liberty Mutual Group, Inc. was represented by Christopher Martin, Levon Hovnatanian and Bruce Ramage of Martin, Disiere, Jefferson & Wisdom, LLP. and we congratulate Liberty Mutual on this significant win.

HOUSTON COURT OF APPEALS GRANTS SUMMARY JUDGMENT FOR INSURER IN SEWAGE-OVERFLOW CASE

Last week, the Fourteenth Court of Appeals affirmed summary judgment in favor of United Fire and Casualty Company in a case involving damage from a sewage overflow. In *Kelley Street Associates, LLC v. United Fire and Cas. Co.*, No. 14-14-00755-CV, 2015 WL 7740450 (Tex. App.—Houston[14th Dist.] Nov. 30, 2015), Kelley reported a claim for flood damage after employees of the City of Houston repaired a water meter and street valves, which caused Kelly's building to flood. Kelley alleged that these employees dislodged debris that then traveled through the water main, entered the building, and damaged flush valves in the building's toilets, which caused septic tanks to fill and flood the building through the floor drains.

United Fire denied the claim based on an exclusion for loss caused by "[w]ater that backs up or overflows from a sewer, drain, sump pump or related equipment." On summary judgment, Kelley argued that the exclusion only applies when a municipal sewer system overflows, but not when the flooding is caused by the failure of the insured's plumbing system. Kelly also argued that the exclusion's term "drain" did not include floor drains, from which the water overflowed in this case.

The trial and appellate courts rejected Kelley's interpretation of the exclusion. The Fourteenth Court of Appeals noted that the exclusion focused on the type of water-related loss, not where the loss originated. The court also looked to other policy provisions that *did* differentiate between loss that originated from outside or inside the insured's property, finding that the parties were capable of including similar language in the sewage-overflow exclusion and that the omission of this language in this exclusion "was purposeful."

The Court of Appeals also rejected Kelley's argument that the term "drain" did not include floor drains. The Court looked to the common definition of "drain" as a "conduit for draining liquid, as a ditch or a pipe," and found that the policy unambiguously excluded flooding from floor drains. Finding the policy exclusion unambiguous, the Court affirmed the trial court's granting of summary judgment in favor of United Fire.

TYLER COURT OF APPEALS REVERSES UNDERINSURED-MOTORIST JUDGMENT IN EXCESS OF POLICY LIMITS

Last week, the Tyler Court of Appeals reversed a jury verdict that imposed greater contract liability on Liberty Mutual than the limits in its underinsured-motorist policy. The verdict in *Liberty Mut. Ins. Co. v. Sims*, No. 12-14-00123-CV, 2015 WL 7770166 (Tex. App.—Tyler Dec. 3, 2015), originated from an automobile accident that injured Rickie Sims while he was driving a commercial vehicle owned by an affiliate of Chesapeake Energy Corporation. Chesapeake had obtained uninsured/underinsured motorist (UM/UIM) coverage through Liberty Mutual Insurance Company. Sims sued the other driver, Liberty, and Sims' personal automobile carrier, Farmers Texas County Mutual Insurance Company.

In Liberty's initial discovery responses, it stated that the Chesapeake policy had UIM limits of \$1,000,000.00. In later supplemental discovery responses, Liberty produced an amendatory endorsement and explained that its limits were actually \$250,000. Five days before trial, the trial court granted Sims' motion for leave to amend its petition to assert new violations based on the Texas Insurance Code and asserting that Chesapeake's UIM limits were \$1,000,000. The trial court also rejected Liberty's request for a ruling that its limits were \$250,000 as a matter of law and, denied its motion to exclude any mention at trial of the higher, incorrect limits. The jury found Liberty liable for the incorrect \$1,000,000 UIM limits.

The Tyler Court of Appeals reviewed the Liberty policy *de novo* to determine whether the policy's provisions regarding the policy limits were ambiguous. The Court found that the policy contained an endorsement that unambiguously set UIM limits at \$250,000 and clearly stated that these limits controlled over the main policy's \$1,000,000 limits. The Court rejected Sims' argument that Liberty's inconsistent discovery responses created a fact issue for the jury to resolve. The Court found that Liberty had properly supplemented its discovery responses to reflect the correct limits and, that they tendered the \$250,000 limits to Sims before trial. The Court also reiterated the well-established principle that a party's conduct cannot modify or expand coverage, stating that Liberty's discovery responses could "not change the trial court's obligation to review and make a legal determination of the policy's terms and UIM limits." The Court also found that the trial court improperly allowed Sims to discuss insurance at trial, especially because it allowed discussion of an incorrect amount of coverage. The Court reversed the judgment and remanded the case for a new trial on damages.