

Update on *U. S. Metals, Inc. v. Liberty Mutual Group, Inc.* and the Aftermath

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U.S. Metals-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 the 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.

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?”

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.

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.”
- Therefore, there is no property damage

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.
- But what about Exxon's loss of use claim?

EXCLUSION M MAY APPLY

- 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.
- Here, not mere replacement but cutting, welding, grinding, etc...right?
- So, M does not apply, so there is coverage for the loss of use, right?

THE COURT DISAGREED

- “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 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.

RIP AND TEAR WITHOUT COVERED PROPERTY DAMAGE FIRST?!?!

- “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

- Thus, under the Court's *U.S. Metals* analysis, the destruction of the insulation and gaskets in order to repair the defective flanges generated new property damage that triggered the CGL policy.

*The Aftermath:
Lauger Companies, Inc. v. Mid-
Continent Cas. Co.*

- Southern District of Texas
- Lauger, the GC, purchased concrete from Mid-Continent's insured. Lauger used the concrete in the foundation, which contained other subs' work (e.g., water/electric/rebar). Later testing determined that the concrete did not meet specs (i.e., not strong enough)

Lauger FACTS

- Due to the defects in the concrete, Lauger demolished the foundation and rebuilt everything. Of course, the rip and tear of the foundation destroyed the other subs' work and/or product
- Lauger sought coverage for its repair under Mid-Continent's policy

Lauger DEFENSES

- Mid-Continent argued that:
 1. There was no recoverable “property damage”
 - No loss of use (unlike *U.S. Metals’* diesel units)
 2. There was no “property damage” within the policy’s coverage period
 3. Exclusion K bars coverage for concrete
 4. There was no occurrence (intentional damages)

Lauger – U.S. Metals

- *U.S. Metals* referenced but not discussed
 - No loss of use here
 - Never addressed whether there is coverage to repair a non-covered defective product
 - Here, there is no covered “property damage,” so costs incurred for destroying other property in order to replace the defective concrete should not be covered because they are not sums the insured is obligated to pay “because of ... property damage to which this insurance applies.”

Lauger FINDINGS

- The court elected to split the costs – no coverage for foundation, but granted indemnity for other work
- Foundation – pouring defective concrete was not a covered physical injury; so no property damage

Lauger FINDINGS

- But, pouring defective concrete “damaged the non-concrete elements of the foundation”
 - Court said they were covered because they could not be repaired; “they were consumed by the faulty concrete”

Lauger – UNANSWERED QUESTIONS

- How were the non-concrete elements damaged?
 - No loss of use
 - Willful destruction caused the damage
- Insured is permitted to create coverage where none previously existed by intentionally causing damage

The Aftermath II: *Travelers Lloyds Ins. Co. v. Cruz Contracting of Texas, LLC*

- The Western District of Texas considered rip & tear damages after *U.S. Metals*
- This case involves the construction of a residential development
- D&D, the GC, subbed out utility work to Cruz (sewer and water systems)

Travelers FACTS

- After Cruz's utility work was completed, D&D and other subs performed road work above Cruz's work
- Nearing completion, it was discovered that Cruz's defective work necessitated the removal of the roadway which also damaged other subs' utility work

Travelers – PROPERTY DAMAGE

- The Court first looked at property damage
- Cruz's defective work was not physically damaging the road and other work
- But the loss of use of the road caused by Cruz's defective work was property damage
- Further, rip & tear costs are property damage under *U.S. Metals*

Travelers – OCCURRENCE

- As to “occurrence” ...
- Question is not “did D&D intentionally damage property to access Cruz’s work”
- Question is “did Cruz intend his defective work to damage the roadway, etc...?”
- Here, Court said no intention or expectation to damage, so there was an occurrence.

Travelers – TIMING

- Travelers then argued that the damage occurred after its relevant policies expired – when the rip & tear occurred
- Court said no. In looking only at pleadings, PD alleged to have occurred during Travelers' term of coverage.

Travelers– IMPAIRED PROPERTY

- Travelers argued that repair of Cruz’s work caused the loss of use of the roadway.
- Therefore, the roadway was “impaired property” that was restored to use by the repair, replacement, adjustment, or removal of Cruz’s defective work.

Travelers– IMPAIRED PROPERTY

- Court found that, sure, impaired property exclusion bars coverage for damages arising from Cruz's defective work
- But, the roadway damage is not excluded because the damage to this property could not be "restored to use" by replacement/removal of Cruz's work

Travelers– IMPAIRED PROPERTY

- “Travelers must show that the property damage would be entirely repaired by simply fixing (or removing) Cruz’s defective work.”
- Therefore, impaired property exclusion was not applicable
- Court compared this to *U.S. Metals*, wherein the removal and replacement of the faulty flanges restored the diesel units to full use

Travelers MEANING

- The Court is permitting the rip and tear to create insurance coverage when there was no coverage prior to the rip and tear.
- Other courts may follow suit and permit the insured to recover rip and tear expenses even though the defective work is not covered

BLUEPRINT FOR THE INSURED

- First, establish a loss of use claim (now have property damage)
- Then, accept that the costs to replace the defective work/product itself is not covered
- Finally, seek all damages associated with accessing defective work (i.e. rip and tear)

CARRIERS RESPOND WITH RIP AND TEAR ENDORSEMENTS

- In light of the uncertainties created by Texas courts, some insurers have created exclusions that limit their exposure for rip and tear costs. The following exclusion (Form AGL04250611) is an example of a rip and tear exclusion.

THE FUTURE?

There is no coverage for “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.

THE FUTURE? ML1333

ENHANCED COVERAGE FOR CONTRACTORS

This endorsement modifies insurance provided under the following:

COMMERCIAL GENERAL LIABILITY COVERAGE PART

Section I – Coverage A – Bodily Injury And Property Damage Liability, Item 2. Exclusions, Paragraph I. Damage To Your Work is deleted and replaced by the following:

2. Exclusions

This insurance does not apply to:

I. Defective Work

“Defective Work” includes any and all costs associated with the removal or replacement of the defective, deficient or faulty work.

The following definition is added to **Section V – Definitions**

- 23.** “Defective Work” means “Your Work” that is defective, deficient, non-conforming, not in accordance with plans and specifications, fails to satisfy applicable building code(s), fails to meet industry practice standards, is not fit for its intended use, not performed in a workman like manner or is faulty, and is included in the products-completed operations hazard.

ML1333

- Removes Exclusion L (which excludes coverage for your work but has a subK exception)
- Defective work is not covered and precludes coverage for rip and tear to remove/replace purely defective work
- There is coverage for non-defective work AND there would be coverage for rip and tear for the covered property damage.

THANK YOU

