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SUPREME COURT OF TEXAS
BLAKE A. HAWTHORNE, CLERK

No. 14-0753

IN THE SUPREME COURT OF THE STATE OF TEXAS

U.S. METALS, INCORPORATED,

Plaintiff – Appellant

v.

LIBERTY MUTUAL GROUP, INCORPORATED,
DOING BUSINESS AS LIBERTY INSURANCE CORPORATION,

Defendant – Appellee,

BRIEF OF *AMICUS CURIAE* UNITED POLICYHOLDERS IN SUPPORT OF APPELLANT

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I. CERTIFIED QUESTIONS AND REQUESTED DISPOSITION

The questions certified for appeal to this Court by the United States Court of Appeals for the Fifth Circuit are:

1. In the "your product" and "impaired property" exclusions, are the terms "physical injury" and/or "replacement" ambiguous?

2. If yes as to either, are the aforementioned interpretations offered by the insured reasonable and thus, must be applied pursuant to Texas law?

3. If the above question 1 is answered in the negative as to "physical injury," does "physical injury" occur to the third party's product that is irreversibly attached to the insured's product at the moment of incorporation of the insured's defective product or does "physical injury" only occur to the third party's product when there is an alteration in the color, shape, or appearance of the third party's product due to the insured's defective product that is irreversibly attached?

4. If the above question 1 is answered in the negative as to "replacement," does "replacement" of the insured's defective product irreversibly attached to a third party's product include the removal or destruction of the third party's product?

United Policyholders, a non-profit advocate for policyholders, respectfully submits this brief to address, in part, the first, third and fourth certified questions as more fully set forth herein.

II. SUMMARY OF ARGUMENT

This Court should answer the first certified question in the affirmative. As other courts have correctly found, the "impaired property" exclusion should be

strictly construed against the insurer and in favor of coverage for the policyholder because it is ambiguous as a matter of law.

Regardless of how the first or second certified questions are answered, United Policyholders respectfully submits that this Court should answer the third certified question by holding that "physical injury" occurs to the third party's product that is irreversibly attached to the insured's product at the moment of incorporation. As more fully discussed below, Texas law permits this Court to consider evidence of drafting history and trade usage to explain or qualify disputed contract language – here, the intent of the "physical injury" language contained in the definition of "property damage" and in conjunction with the "impaired property" exclusion. The drafting history evidence surrounding the development of standard commercial general liability insurance policy language like that at issue here demonstrates that the insurance industry intended for coverage to continue to be provided for property damage arising out of the mere incorporation of a defective product even where, as here, the policy language includes the term "physical injury" in the definition of "property damage."

Finally, and regardless of how the first or second certified questions are answered, this Court should answer the fourth certified question in the negative. The better reasoned case law authorities and insurance industry commentary confirm that the exclusion should not apply where impaired third party property is

irreversibly attached to or incorporates an insured's defective product and cannot be restored to use without replacing that product.

III. STATEMENT OF INTEREST OF *AMICUS CURIAE*

United Policyholders ("UP") is a non-profit 501(c)(3) organization founded in California in 1991 that is a voice and an information resource for insurance consumers in all 50 states, whether businesses or individuals. UP is dedicated to educating the business community and the general public on insurance issues and consumer rights. UP protects the interests and presents the positions of policyholders through participation as *amicus curiae* in insurance coverage cases throughout the country. Donations, foundation grants and volunteer labor support the organization's work. UP does not accept funding from insurance companies.

UP's work is divided into three program areas: *Roadmap to Recovery*™ (disaster recovery and claim help), *Roadmap to Preparedness* (insurance and financial literacy and disaster preparedness), and *Advocacy and Action* (advancing pro-consumer laws and public policy). UP hosts a library of tips, sample forms and articles on commercial and personal lines insurance products, coverage and the claims process at www.uphelp.org. Texas home and business owners use our "Ask an Expert" forum and disaster recovery resources.

The organization interfaces with Texas' Insurance Commissioner in proceedings of the National Association of Insurance Commissioners where we serve as an official representative of insurance policyholders.

Through a network of volunteers and advisers throughout the country, UP offers assistance to state and federal courts as amicus curiae. Information and arguments in our briefs on issues including the reasonable expectations of policyholders and the interpretation of insurance contracts have been included in U.S. Supreme Court and numerous appellate court decisions. UP has participated as amicus curiae in more than 300 cases throughout the United States, including a significant number of coverage matters adjudicated in Texas state courts and the Fifth Circuit. *See, e.g.*, *Gilbert Texas Constr., L.P. v. Underwriters at Lloyd's London*, 327 S.W.3d 118 (Tex. 2010); *In re Universal Underwriters of Texas Ins. Co.*, 345 S.W.3d 404 (Tex. 2011); *Pendergest-Holt v. Certain Underwriters at Lloyd's of London*, 600 F.3d 562 (5th Cir. 2010); *Citigroup Inc. v. Federal Ins. Co.*, 649 F.3d 367 (5th Cir. 2011); *Advanced Env. Recycling Tech. Inc. v. Am. Int'l Specialty Lines Ins. Co.*, 399 F. App'x 869 (5th Cir. 2010); *Nat'l Union Fire Ins. Co. of Pittsburgh, PA v. Crocker*, 246 S.W.3d 603 (Tex. 2008); *Motiva Enters., LLC v. St. Paul Fire & Marine Ins. Co.*, 445 F.3d 381 (5th Cir. 2006); *Fairfield Ins. Co. v. Stephens Martin Paving, LP*, 246 S.W.3d 653 (Tex. 2008); *Excess*

Underwriters at Lloyd's, London v. Franks Casing Crew & Rental Tools, Inc., 246 S.W.3d 42 (Tex. 2008).

IV. ARGUMENT

A. Texas' Principles for Construing Insurance Policy Provisions

It is well-settled that Texas courts maintain the value of insurance and keep a level playing field between the state's residents and insurance companies by applying and enforcing the doctrine of *contra proferentem* – *i.e.*, ambiguous language in an insurance policy is to be interpreted in favor of coverage. *See Evanston Ins. Co. v. Legacy of Life*, 370 S.W.3d 377, 380 (Tex. 2012) (interpreting ambiguous language in favor of the insured); *Gilbert Texas Constr., L.P. v. Underwriters at Lloyd's London*, 327 S.W.3d 118, 133 (Tex. 2010) (same); *Don's Bldg. Supply, Inc. v. OneBeacon Ins. Co.*, 267 S.W.3d 20, 23 (Tex. 2008) (same); *Evanston Ins. Co. v. ATOFINA Petrochems., Inc.*, 256 S.W.3d 660, 668 (Tex. 2008) (same); *ATOFINA Petrochems., Inc. v. Cont'l Cas. Co.*, 185 S.W.3d 440, 444 (Tex. 2005) (same); *Progressive Cnty. Mut. Ins. Co. v. Sink*, 107 S.W.3d 547, 551 (Tex. 2003) (same). Thus, "when the language of the insurance contract is ambiguous, that is, is subject to two or more reasonable interpretations, then that construction which affords coverage ***will be the one adopted***." *See Glover v. National Ins. Underwriters*, 545 S.W.2d 755, 761 (Tex. 1977).

The policy of strict construction against the insurer is especially strong when the court is dealing with exceptions and words of limitation. *See Blaylock v. American Guarantee Bank Liab. Ins. Co.*, 632 S.W.2d 719, 721 (Tex. 1982); *State Farm Mut. Auto. Ins. Co. v. Owens*, 308 S.W.2d 189, 193 (Tex. 1957) ("[p]rovisions inserted in a contract by the insurer which tend to defeat, diminish or forfeit the insurance will be construed strictly against the insurer"); *see also Urethane Int'l Products v. Mid-Continent Cas. Co.*, 187 S.W.3d 172, 176 (Tex. 2006) (interpreting exclusion in favor of insured). It is settled law in Texas that when the interpretation of an exclusionary or coverage-limiting clause is at issue, courts "must adopt the construction of an exclusionary clause urged by the insured as long as that construction is not unreasonable, ***even if*** the construction urged by the insurer appears to be more reasonable or a more accurate reflection of the parties' intent." *National Union Fire Ins. Co. of Pittsburgh, Pa. v. Hudson Energy Co., Inc.*, 811 S.W.2d 552, 555 (Tex. 1991) (emphasis added); *see also Tolar v. Allstate Texas Lloyd's Co.*, 772 F. Supp. 2d 825, 830 (N.D. Tex. 2011); *Utica Nat'l Ins. Co. v. Am. Indem. Co.*, 141 S.W.3d 198, 202 (Tex. 2004) (when constructing exclusions, court must adopt the construction urged by the insured if that construction is not unreasonable, ***even if*** construction urged by insurer seems more reasonable).

For each of the following reasons, the "impaired property" exclusion and the term "physical injury" as used within it are ambiguous and must be construed in favor of coverage for the policyholder.

B. The "Impaired Property" Exclusion is Inherently Ambiguous.

This Court should answer the first certified question in the affirmative. The "impaired property" exclusion is ambiguous on its face. Since its introduction to the standard commercial general liability policy form in 1986, commentators have opined that the exclusion is "too complex for a uniform interpretation," "difficult," "tricky," and "subject to attack as unintelligible or at least ineffective to overcome the insured's reasonable expectations of coverage." *See* Bruner, Philip L. and Patrick J. O'Conner, Jr., 4 Bruner and O'Connor Construction Law, §11.106 (other citations omitted).

As noted in the Fifth Circuit's *per curiam* decision dated September 19, 2014 certifying this matter for appeal in this Court, the pertinent part of the "impaired property" exclusion precludes coverage for:

> "Property damage" to "impaired property" or property that has not been physically injured, arising out of:
>
> (1) A defect, deficiency, inadequacy or dangerous condition in "your product" or "your work"[.]

See U.S. Metals, Inc. v. Liberty Mut. Group, Inc., 589 Fed.Appx. 659, 660-61 (5th Cir. 2014).

Because the "impaired property" exclusion incorporates various defined terms (including the term "property damage"), those definitions must be read into the exclusion in order to discern its meaning. "Property damage" is defined 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; or
>
> b. Loss of use of tangible property that is not physically injured. All such loss of use shall be deemed to occur at the time of the "occurrence" that caused it.

Id. at 660. The term "physical injury" is *not defined* in the Policy.

The Policy at issue defines "impaired property" as follows:

> "Impaired Property" means 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; or
>
> b. You have failed to fulfill the terms of the contract or agreement;
>
> if such property can be restored to use by the repair, replacement, adjustment or removal ***of "your product"*** or "your work" or your fulfilling the terms of the contract or agreement.

Id. at 661.

Courts outside of Texas and insurance law commentators have criticized this exclusion as ambiguous. *See, e.g., Serigne v. Wildey*, 612 So. 2d 155, 158 (La. Ct. App. 1992) *writ denied*, 613 So. 2d 994 (La. 1993) (impaired property exclusion is "ambiguous and/or in conflict with other segments of the policy defining coverage."); *accord St. Martin & Mahoney, APLC v. Eagle Aviation, Inc.*, Civ. A.

94-1421, 1995 WL 766337, at *4-5 (E.D. La. Dec. 28, 1995) (impaired property exclusion is ambiguous and in conflict with definition of "occurrence"). *See also, Watts Indus., Inc. v. Zurich American Ins. Co.*, 121 Cal.App.4th 1029, 1048 n.4 (Cal. Ct. App. 2004) ("We note that various commentators or courts have found the impaired property exclusion to be problematic, ambiguous, 'difficult,' 'tricky,' 'unintelligible,' or 'too complex to receive a uniform interpretation.'" (other citations omitted)).

In *Computer Corner, Inc. v. Fireman's Fund Ins. Co.*, 46 P.3d 1264 (Ct. App. N.M. 2002), the Court of Appeals of New Mexico construed the impaired property exclusion in a CGL coverage case involving the loss of data stored on a computer hard drive. The court began its analysis by noting that the first sentence of the exclusion incorporates two defined terms, "property damage" and "impaired property," and as its first step toward trying to understand the exclusion, replaced the term "property damage" with its definition. *Id.* at 1269. The court said: "[T]he first phrase appears to contemplate the following alternatives: (1) physical injury to…impaired property [a defined term], and (2) physical injury to property that has not been physically injured. This second alternative – physical injury to property that has not been physically injured – is nonsensical." *Id.*

The court continued its analysis by replacing the defined term "impaired property" – which definition incorporates the defined terms "your work" and "your

product," to arrive at the unabridged version of the impaired property exclusion, which purports to exclude coverage for:

> Physical injury to tangible property, including all resulting use of that property, to tangible property, other than any goods, products, or property manufactured, sold, handled, distributed or disposed of by you or work or operations performed by you or on your behalf, that cannot be used or is less useful because it incorporates any goods, products, or property manufactured, sold, handled, distributed or disposed of by you or work or operations performed by you or on your behalf 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 any goods, products, or property manufactured, sold, handled, distributed or disposed of by you or work or operations performed by you or on your behalf or property that has not been physically injured.

Id. The court found that the replacement of the defined terms with their definitions resulted in a "semantic bog that would be extremely discouraging to a layperson attempting to read and understand this exclusion." *Id.* at 1269-70. Calling the exclusion "unintelligible," the court proclaimed that it found it "difficult to believe that anyone genuinely interested in communicating information to another person – whether in a cookbook, a home appliance manual, or a contract – would employ the type of convoluted, intractable language used in the Fireman's policy." *Computer Corner, Inc.*, 46 P.3d at 1270.

Rather than attempt to ascertain whether the claim brought by the insured was excluded by the impaired property exclusion, the Court "declined to 'attempt to construe that which may well be impossible of construction' because by doing

so we encourage the perpetuation of the type of unintelligible language of which [the impaired property exclusion] of Fireman's policy is a perfect example" *Id.* Instead, the court held that the provision was "too vague and indefinite to be enforceable." *Id.*

Because the "impaired property" exclusion suffers from any intelligible construction in light of its patent ambiguity, it should be strictly construed against the insurer and in favor of the policyholder in accordance with Texas' rules of insurance contract interpretation. *See Glover*, 545 S.W.2d at 76177) ("[W]hen the language of the insurance contract is ambiguous, that is, is subject to two or more reasonable interpretations, then that construction which affords coverage ***will be the one adopted***." *Id.* (emphasis added).

C. Insurance Industry Drafting History and Trade Usage Evidence Confirms That Adding "Physical Injury" to the Definition of "Property Damage" Was Not Intended to Limit Coverage for Third Party Property Damage Arising Out of the Mere Incorporation of an Allegedly Defective Product.

Insurers should not be permitted to deny coverage for claims related to incorporated product damages on the basis that the incorporation of a policyholder's allegedly defective product, standing alone, is not "physical injury" as that term is used in connection with the "impaired property" exclusion. Insurance industry drafting history and trade usage evidence confirms that the insurance industry intended to provide coverage for third party property damage

claims arising out of the mere incorporation of a policyholder's allegedly defective product even after standard CGL policy form language was revised in 1973 to include the term "physical injury" in the definition of "property damage." *See generally* Lorelie S. Masters and Richard P. Lewis, *Coverage for "Incorporation" of a Policyholder's Defective Products Into Third Party Property*, COVERAGE Vol. 5, No. 6, Nov/Dec 1995 (American Bar Association).

As more fully set forth below, this Court may properly consider this drafting history evidence under Texas law. This evidence demonstrates that, regardless of how the first or second certified questions are answered, this Court should answer the third certified question by construing the term "physical injury" as occurring to a third party's product that is irreversibly attached to the insured's product at the moment of incorporation.

1. Evidence of Trade Usage and Insurance Industry Drafting History is Admissible to Explain Specialized Industry Contract Language.

While parol evidence of the parties' intent is not admissible to create an ambiguity, a contract may be read in light of the surrounding circumstances to determine whether an ambiguity exists. *See Balandran v. Safeco Ins. Co. of Am.*, 972 S.W.2d 738, 741-43 (Tex. 1998) (reviewing the "circumstances surrounding the drafting of th[e] policy" to interpret the meaning of a disputed exclusionary provision). Evidence of trade usage and course of conduct is admissible to explain, supplement, or qualify a term or an agreement, but it may not be used to contradict

an express term. *Craig Sessions, M.D., P.A. v. TH Healthcare, Ltd.*, 412 S.W.3d 738 (Tex. App.--Texarkana 2013, no pet.); *Transcon. Gas Pipeline Corp. v. Texaco*, Inc., 35 S.W.3d 658, 670 (Tex. App. 2000). In particular, a specialized industry or trade term may require extrinsic evidence of the commonly understood meaning of the term within a particular industry. *Coterill-Jenkins v. Texas Med. Ass'n Health Care Liab. Claim Trust*, 383 S.W.3d 581, 588 (Tex. App. – Houston [14th Dist.] 2012, pet. denied) (citing *Nat'l Union Fire Ins. Co. of Pittsburgh, PA v. CBI Indus., Inc.*, 907 S.W.2d 517, 521 n.6 (Tex. 1995) and noting that extrinsic evidence may be consulted in determining the commonly understood meaning of terms within a particular "place, vocation, trade, or industry").

Within this framework, this Court may properly consider drafting history evidence surrounding the evolution of standard commercial general liability insurance policy forms and the insurance industry's trade usage and intent that such policies cover "incorporated product" cases. As set forth below, the standard commercial general liability insurance policy form issued prior to and during 1966, as well as subsequent revisions issued by the insurance industry in 1973 and 1986, all were intended to provide coverage for "incorporated product" cases.

2. Numerous Courts Held That CGL Policies Predating the Definition of "Property Damage" in the 1966 Standard Form Covered Third Party Property Damage Arising From Incorporated Products.

Although "property damage" was not a defined policy term prior to the development of the 1966 standard commercial general liability insurance ("CGL") policy form,[1] numerous courts held that damage to third party property arising out of the incorporation of a policyholder's allegedly defective product was covered under standard CGL policies issued prior to 1966. *See Dakota Block Co. v. Western Cas. & Sur. Co.*, 132 N.W.2d 826, 830 (S.D. 1965); *Western Cas. & Sur. Co. v. Polar Panel Co.*, 457 F.2d 957, 960 (8th Cir. 1972); *Pittsburgh Bridge & Iron Works v. Liberty Mut. Ins. Co.*, 444 F.2d 1286, 1290 (3d Cir. 1971); *Bowman Steel Corp. v. Lumbermens Mut. Cas. Co.*, 364 F.2d 246, 249-50 (3d Cir. 1966); *Bundy Tubing Co. v. Royal Indem. Co.*, 298 F.2d 151, 154 (6th Cir. 1962); *Gogerty v. Gen. Acc., Fire & Life Assur. Corp.*, 238 Cal.App.2d 574, 578-79 (Cal. App. 1964); *Geddes & Smith, Inc. v. St. Paul-Mercury Indem. Co.*, 334 P.2d 881, 885

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[1] The first standard comprehensive general liability insurance policy form was developed in 1940 by two insurance company trade groups. *See* George H. Tinker, *Comprehensive General Liability Insurance – Perspective and Overview*, 25 Fed'n Ins. Counsel Quarterly 217, 218-220 (Spring 1975). Significant revisions to the standard CGL policy form were made by The Insurance Services Office ("ISO") or its predecessor organizations in 1966, 1973 and 1985. *See, e.g., In re Ins. Antitrust Litig.*, 938 F.2d 919, 923 (9th Cir. 1991) rev'd in part on other grounds *Hartford Fire Ins. Co. v. California*, 509 U.S. 764 (1993); *see also Hoechst Celanese Corp. v. Nat'l Union Fire Ins. Co. of Pittsburgh, PA*, 623 A.2d 1128, 1129 n.1 (Del. Super. 1992) ("most if not all insurers use ISO standard-form language in their policies").

(Cal. 1959); *Beacon Textiles Corp. v. Employers Mut. Liab. Ins. Co.*, 246 N.E.2d 671, 673 (Mass. 1969); *Hauenstein v. St. Paul-Mercury Indem. Co.*, 65 N.W.2d 122, 125 (1954); *Ramco, Inc. v. Pacific Ins. Co.*, 439 P.2d 1002, 1005 (Ore. 1968).

In *Dakota Block Co.*, for example, the Supreme Court of South Dakota held that the incorporation of defective bricks was deemed to have caused covered property damage to the entire building:

> We are satisfied that common sense dictates there was substantial property damage to the entire school building when the exterior walls presented a faded, discolored, mottled and unsightly appearance in contrast to a uniform and eye-pleasing manifestation envisioned by the original plans. To say the damage in such instance can be confined to the blocks as distinct from the school building, we feel, is unrealistic and loses sight of the forest because of the trees. ***Although plaintiff offered no direct evidence that the value of the building was diminished by reason of the defective blocks, in our opinion, the fact of the owner's dissatisfaction, the architect's complaint, the protracted negotiations to settle differences, and the uncontradicted testimony of costs of reconstruction lead to the inevitable conclusion of a damaged structure caused by plaintiff's defective product.*** This places the loss within the policy coverage.

Dakota Block Co., 132 N.W.2d at 830 (emphasis added).

3. Case Law and The Drafting History of the 1966 Standard CGL Form Demonstrates That the Insurance Industry Intended to Continue to Cover Third Party Property Damage Arising Out of Incorporated Products.

The drafting history surrounding the development of the 1966 revisions to the standard CGL policy form, as well as case law authority interpreting product incorporation cases under that form, demonstrates that the insurance industry intended to continue to cover third party property damage arising out of

incorporated products. Among other changes, the drafters of the 1966 standard CGL policy form added "property damage" as a defined term meaning, in pertinent part, "injury to or destruction of tangible property." *See* Rowland H. Long, *The Law of Liability Insurance* §§ 11.01[2][c].

An important piece of drafting history is reflected in a question and answer discussion during a panel at a 1965 meeting of the Mutual Insurance Technical Conference Proceedings, Casualty and Automotive Underwriting Conference, sponsored by the Mutual Insurance Advisory Association and the Mutual Insurance Rating Bureau.[2] In response to a question, Richard Schmalz, Liberty Mutual's representative on the National Bureau of Casualty Underwriters'("NBCU") and Mutual Insurance Rating Bureau's ("MIRB")[3] Joint Drafting and Joint Forms Committees, which were responsible for developing the

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[2] *See* Lorelie S. Masters and Richard P. Lewis, *Coverage for "Incorporation" of a Policyholder's Defective Products Into Third Party Property*, COVERAGE Vol. 5, No. 6, Nov/Dec 1995 at 21 n. 17 (American Bar Association) (herein "Masters and Lewis") (identifying the panelists as consisting of Richard A. Schmalz of Liberty Mutual Insurance Company, R. P. Rose of Michigan Mutual Liability Company, George F. Mitchell of Utica Mutual Insurance Company, and Gilbert L. Bean of Liberty Mutual Insurance Company).

[3] The MIRB and the NBCU were insurance industry-supported rating and drafting organizations. In 1960, these organizations established several committees – including the Joint Drafting Committee and the Joint Rating Committee – which engaged in the CGL policy revision process. *See generally In re Insurance Antitrust Litig.*, 938 F.2d at 922-24; *Amer. Home Products Co. v. Liberty Mut. Ins. Co.*, 565 F. Supp. 1485, 1501 (S.D.N.Y. 1983). The two groups, and others, later merged to form the Insurance Services Office ("ISO").

1966 Form,[4] told the audience that, under the 1966 Form, "incorporated product" cases would continue to be covered:

> CHAIRMAN WRIGHT: Here is another one for you: Under the new [1966] policy's coverage grant [(insuring agreement)], it is possible that a claimant may recover for the cost of replacing and repairing the insured's product if there has been no damage other than to the insured's own product? What is the intent? This does not refer to sistership.
>
> Example: The conduit manufactured by the insured and embedded in concrete is faulty due to negligent handling by the insured's employees. Must the policy pay for its removal and replacement even though it has only "damaged" itself?
>
> MR. SCHMALZ: I think the answer to that is yes, and again we are in a difficult area, but this case is very much like the [*Bundy Tubing*] case. I don't know if the people are familiar with it or not, but tubing was imbedded for radiant heating purposes in either a ceiling or a floor. I have forgotten which, in a number of buildings, and the tubing developed leaks and, as a result, the concrete had to be ripped up in order to replace the tubing. ***All courts seem to say in the situation where the insured's product is incorporated in a building or somebody else's work product so that the value of the other work expended in utilizing the product has to be destroyed in order to remedy the situation, that everything except the cost of the product itself is payable under a standard policy. I think there has been no change in the intent in this particular area and that we can expect exactly the same type of result to obtain as under the old policy. The [Hauenstein] case and the [Bundy Tubing] case will continue to be covered***.

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[4] Mr. Schmalz was also one of three members of the Joint Scope of Coverage Subcommittee of the NBCU. *See* Masters and Lewis at n. 19. That Subcommittee "held the authority of final approval in determining whether the [standard policy] language comported" with "[t]he ultimate underwriting intent of the form policy language." *Id.* (citing *Asbestos Ins. Coverage Cases (Phase V-A)*, Cal. Super., Judicial Council Coordination Proceeding No. 1072, slip op. at 34 (Jan. 24, 1990)).

See Lorelie S. Masters and Richard P. Lewis, Coverage for "Incorporation" of a Policyholder's Defective Products Into Third Party Property, COVERAGE Vol. 5, No. 6, Nov/Dec 1995 at 21-22, n. 22 (American Bar Association) (citing Richard A. Schmalz, et al., *New Comprehensive General Liability and Automobile Programs*, 1965 Mutual Insurance Technical Conference Proceedings, Casualty and Automotive Underwriting Conference 1, 34 (Nov. 15-18, 1965) (sponsored by the Mutual Insurance Advisory Association and the MIRB and held at the Edgewater Beach Hotel, Chicago, Ill.) (comments of Richard A. Schmalz, Assistant Counsel, Liberty Mutual Insurance Company)) (emphasis added).

This drafting history reflects the insurance industry's intent that the 1966 Form cover incorporation damages, as evidenced by the drafters' representations at the time it was presented for consideration.

Consistent with this industry intent, numerous case law authorities addressing coverage disputes over product incorporation issues under the 1966 standard CGL policy form have held that the incorporation of a policyholder's allegedly defective product into third party property causes "injury to or destruction of" that property under the 1966 standard CGL policy form. *See, e.g. Maryland Casualty Co. v. W.R. Grace & Co.*, 23 F.3d 617, 627 (2d Cir. 1993), amended, (May 16, 1994); *St. Paul Fire & Marine Ins. Co. v. Sears, Roebuck & Co.*, 603 F.2d 780, 784-85 (9th Cir. 1979); *Goodyear Rubber & Supply Co. v.*

Great Am. Ins. Co., 471 F.2d 1343, 1344-46 (9th Cir. 1973); *Aetna Cas. & Sur. Co. v. PPG Indus., Inc.*, 554 F. Supp. 290, 293-94 (D. Ariz. 1983); *Cargill, Inc. v. Liberty Mut. Ins. Co.*, 488 F. Supp. 49, 52-53 (D. Minn. 1979), *aff'd*, 621 F.2d 275 (8th Cir. 1980); *Arcos Corp. v. American Mut. Liab. Ins. Co.*, 350 F. Supp. 380, 383 (E.D. Pa. 1972), *aff'd*, 485 F.2d 678 (3d Cir. 1973); *United States Fidel. & Guar. Co. v. Amer. Ins. Co.*, 345 N.E.2d 267, 271 (Ind. App. 1976); *Continental Cas. Co. v. Gilbane Bldg. Co.*, 461 N.E.2d 209, 213 (Mass. App. 1984); *Sturges Mfg. Co. v. Utica Mut. Ins. Co.*, 332 N.E.2d 319, 322 (N.Y. App. 1975).

Indeed, as one commentator who represented the insurer in the seminal case *Keene Corp. v. Ins. Co. of N. Am.*, 667 F.2d 1034 (D.C. Cir. 1981), has written:

> It is firmly established that the incorporation of a defective product into tangible property constitutes property damage under the language of the 1966 policy ***even absent physical injury to the larger property***, if it results in a decrease in the market value of the property.

See John P. Arness & Randall D. Eliason, *Insurance Coverage for "Property Damage" in Asbestos and Other Toxic Tort Cases*, 72 Va. L. Rev. 943, 953 n.31 (emphasis added).

As confirmed in the case law, commentary and drafting history addressing the development of the 1966 standard CGL policy form (which predates the inclusion of "physical injury" in the definition of "property damage"), standard CGL policies from this era were intended to provide coverage for third party property damage claims arising out of the mere incorporation of a policyholder's

allegedly defective product. As set forth more fully below, this intent continued through later revisions of the standard CGL policy form containing the term "physical injury" in the definition of "property damage."

4. Insurers' Assertions That Mere Product Incorporation is Not "Physical Injury" is Contrary to Insurance Industry Drafting History Surrounding the Development of That Policy Language in 1973.

Insurers' assertions that the mere incorporation of a policyholder's allegedly defective product by itself is not "physical injury" is directly contrary to the drafting history evidence generated at the time the insurance industry developed the 1973 standard CGL policy form. The industry revised the 1973 standard CGL policy form by including, among other changes, a two-pronged definition of the term "property damage" as follows:

> (1) ***physical injury*** to or destruction of tangible property which occurs during the policy period, including the loss of use thereof at any time resulting therefrom, or
>
> (2) loss of use of tangible property which has not been physically injured or destroyed provided such loss of use is caused by an occurrence during the policy period.

See 2 Long, at § 11.01[1][a] (emphasis added). This definition of "property damage" developed by the insurance industry in 1973 is functionally identical to that contained in the Appellant's insurance policy at issue in the instant case.

Importantly, in circulating the 1973 standard CGL policy form to various state insurance departments for approval, "[t]he filing memorandum written by the Insurance Services Office to the various state insurance departments notes that this

change in definition is designed to be a clarification of intent, and not a change in intent" from the prior 1966 standard CGL policy form. *See* George H. Tinker, *Comprehensive General Liability Insurance – Perspective and Overview*, Fed'n Ins. Counsel Quarterly 217, 232-33 (Spring 1975) (emphasis added). Thus, the revised definition of "property damage" in the 1973 standard CGL policy form (which is nearly identical to that in the Liberty Mutual policy at issue here) should not be construed as a narrowing of coverage from that provided under the prior 1966 standard form.

As importantly, other drafting history evidence surrounding the development of the 1973 standard CGL policy form is in accord. *See generally* Lorelie S. Masters and Richard P. Lewis, *Coverage for "Incorporation" of a Policyholder's Defective Products Into Third Party Property*, COVERAGE Vol. 5, No. 6, at 23-26 Nov/Dec 1995 (American Bar Association).

For example, a transcript generated in connection with a 1972 a panel discussion held by the Mutual Insurance Technical Conference, Casualty and Automotive Underwriting Conference concerning the changes to the 1973 standard form CGL policy language ends with a quote by panelist Robert Cook.[5] *Id.* at 25.

[5] Mr. Cook served on that panel in his capacity as Assistant General Attorney of the Liberty Mutual Insurance Company, along with Robert L. Young, Midwest Underwriting Manager, Employers Mutual Liability Insurance Company; and John L. Kenny, attorney for the Insurance Advisory Bureau. *Id.*at n. 53.

Mr. Cook confirmed that the language in the 1973 standard CGL policy form, like that contained in the 1966 standard form, was intended to continue to provide coverage for third party property damage claims arising out of the incorporation of the policyholder's allegedly defective product:

> Now there is another question I have: "A paint manufacturer sells a paint to a customer which when applied begins to change color after six months, resulting in a very messy looking situation. Is the paint manufacturer's liability covered under the New Exclusion M? Would coverage have been in effect under the old policy, Exclusion K?
>
> I think it would under both the old and the new policies. I think that this is clearly covered. The courts have said so under the pre-1966 policy in several cases. One is the old *Pittsburgh Paint* case [sic][6] where the paint was applied to venetian blinds and the paint deteriorated and the blinds rusted and so forth, and of course the value of the paint was very minor compared to the value of the blinds and the cost of repairing the situation was fairly substantial.
>
> The court held that ***this of course was property damage that was not to the insured's own product***, although the paint deteriorated, ***because*** the paint lost its identity, ***it was incorporated into something larger***, and you have a series of cases along that line; the plaster that failed in the building, requiring that it all be taken off and repaired, that is covered. . . .
>
> The answer then in my opinion is that the paint manufacturer's liability is covered, under the old as well as the new policies.[7]

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[6] *Pittsburgh Plate Glass Co. v. Fidelity & Casualty Co.*, 281 F.2d 538 (3d Cir. 1960) ("*Pittsburgh Plate*") (costs of removing defective paint incorporated into venetian blinds were covered under the incorporation doctrine).

[7] *See* Lorelie S. Masters and Richard P. Lewis, *Coverage for "Incorporation" of a Policyholder's Defective Products Into Third Party Property*, COVERAGE Vol. 5, No. 6, Nov/Dec 1995 at 25-26 n. 56 (American Bar Association) (citing Robert L. Young, *et al.*, General Liability Policy, 1972 Mutual Insurance Technical

Further insurance industry drafting history evidence of this intent is set forth in correspondence from 1972 from the General Counsel for Aetna Life & Casualty Company concluding that the 1973 standard CGL policy form covers property damage arising out of product incorporation:

> As you are aware, the term "physical injury" has not been construed by the courts in the context of injury to tangible property. I believe, however, that it would be held that any visible or detectable deleterious change in the form or composition of the tangible property will be construed to be "physical injury."
>
> Your hypothetical concerning defective lacquer incorporated into soda cans presents an unclear problem which is probably unique to the container coating industry. If the soda cans are rendered useless, they are injured, but at what point can a factual determination be made that the soda cans are "physically injured"? When the metal taste leaches from the can to the soda, or when the defective lacquer is incorporated into the metal can, or when the lacquer is detected to have failed to adhere to the can? While the mere incorporation of a defective product does not necessarily cause it physical injury at the time of incorporation, we would consider the cans to be physically injured at the time it is detected that the lacquer had failed to adhere to the can.[8]

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Conference Proceedings, Casualty and Automotive Underwriting Conference 21, 23, 36-37 (Nov. 13-15, 1972) (panel discussion) (sponsored by the Insurance Advisory Bureau and the Mutual Insurance Advisory Association and held at the Bellevue Stratford Hotel, Philadelphia, Pa.) (comments of Robert Cook, Assistant General Counsel, Liberty Mutual Insurance Company) (emphasis added)).

[8] *See* Lorelie S. Masters and Richard P. Lewis, *Coverage for "Incorporation" of a Policyholder's Defective Products Into Third Party Property*, COVERAGE Vol. 5, No. 6, Nov/Dec 1995 at 26 n. 58 (American Bar Association) (citing letter dated December 18, 1972, from David Edwards, general counsel for Aetna Life & Casualty Co. to Robert F. Bauer, Vice President of Johnson & Higgins).

The significance of this drafting history evidence cannot be overstated. It demonstrates that the insurance industry intended for standard CGL policy forms to continue to provide coverage for property damage arising out of the mere incorporation of a defective product even where, as here, the policy language was revised to include "physical injury" in the definition of "property damage."

As the Fifth Circuit noted in its decision certifying this matter for appeal before this Court, the Seventh Circuit in *Eljer Mfg., Inc. v. Liberty Mut. Ins. Co.*, 972 F.2d 805, 807-14 (7th Cir. 1992) relied on drafting history evidence in holding that "physical injury" occurs to another product at the moment of incorporation of the insured's defective product. As the Seventh Circuit in *Eljer* observed:

> what the draftsmen of the Comprehensive General Liability Insurance policy apparently intended and what rational parties to such a policy would intend in order to make the policy's coverage real and not illusory, is a loss that results from physical contact, physical linkage, as when a potentially dangerous product is incorporated into another and, because it is incorporated and not merely contained (as a piece of furniture is contained in a house but can be removed without damage to the house), must be removed, at some cost, in order to prevent the danger from materializing.

Eljer Mfg., Inc., 972 F.2d at 810. The Court in *Eljer* thus concluded:

> [T]he drafting history of the property-damage clause, and the probable understanding of the parties to liability insurance contracts, persuade us that the ***incorporation of a defective product into another product inflicts physical injury in the relevant sense on the latter at the moment of incorporation***….

Id. at 814 (emphasis added).

Numerous other courts have issued similar holdings involving the 1973 standard CGL policy form consistent with the insurance industry drafting history analyzed above. *See, e.g., Travelers Ins. Co. v. Penda Corp.*, 974 F.2d 823, 832 (7th Cir. 1993); *Imperial Cas. & Indem. Co. v. High Concrete Structures, Inc.*, 858 F.2d 128, 134 (3d Cir. 1988); *Ohio Cas. Ins. Co. v. Bazzi Constr. Co.*, 815 F.2d 1146, 1149 (7th Cir. 1987); *Firemen's Ins. Co. v. Bauer Dental Studio, Inc.*, 805 F.2d 324, 325 (8th Cir. 1986); *Pittsburgh Plate*, 281 F.2d at 538, 541 (3d Cir. 1960); *Johnson v. Studyvin*, 828 F. Supp. 877, 883 (D. Kan. 1993); *Colonial Gas Co. v. Aetna Cas. & Sur. Co.*, 823 F. Supp. 975, 980-81 (D. Ma. 1993); *United States Fidel. & Guar. Co. v. Barron Indus., Inc.*, 809 F. Supp. 355, 360-61 (M.D. Pa. 1992).

Insurers that have denied coverage in a product incorporation case, as Liberty Mutual here, typically argue that the Illinois Supreme Court in *Travelers Ins. Co. v. Eljer Mfg., Inc.*, 757 N.E.2d 481 (Ill. 2001), declined to follow the Seventh Circuit's reasoning in *Eljer*. *Id.* at 502. The Illinois Supreme Court refused to follow the Seventh Circuit, however, because it held that the term "property damage" in the policies at issue was clear and unambiguous, and therefore it was "unnecessary…to consider extrinsic evidence of the policy's purported meaning." *See Travelers Ins. Co. v. Eljer Mfg., Inc.*, 757 N.E.2d 481, 502 (Ill. 2001).

This Court should disregard the Illinois Supreme Court's reasoning in *Eljer* because Texas law permits this Court to consider the drafting history evidence outlined *supra* in determining the intent of the "physical injury" language contained in the definition of "property damage" and in conjunction with the "impaired property" exclusion. *See Balandran*, 972 S.W.2d at 741-43 (reviewing the "circumstances surrounding the drafting of th[e] policy" to interpret the meaning of a disputed exclusionary provision); *TH Healthcare, Ltd.*, 412 S.W.3d at 745-46 (evidence of trade usage is admissible to explain or qualify a contract term); *Transcon. Gas Pipeline Corp.*, 35 S.W.3d at 670 (same). This drafting history evidence demonstrates that the insurance industry intended that coverage would continue to be provided for property damage arising out of the mere incorporation of a defective product even where, as here, the policy language was revised to include "physical injury" in the definition of "property damage."

Applying this drafting history evidence here, this Court should answer the third certified question by holding that "physical injury" occurs to the third party's product that is irreversibly attached to the insured's product at the moment of incorporation.

D. "Replacement" of the Insured's Defective Product Irreversibly Attached to a Third Party's Product Does Not Include the Removal or Destruction of the Third Party's Product

Regardless of whether the term "replacement" is deemed to be ambiguous as used in connection with the "impaired property" exclusion, the better reasoned

case law authorities and insurance industry commentary confirm that the exclusion should not apply where impaired third party property is irreversibly attached to or incorporates an insured's defective product and cannot be restored to use without replacing or damaging the third party property. *See Federated Mut. Ins. Co. v. Grapevine Excavation, Inc.*, 197 F.3d 720, 727-28 (5th Cir. 1999); *see also Martco Ltd. P'ship v. Wellons, Inc.*, 588 F.3d 864, 876 (5th Cir. 2009); *Essex Ins. Co. v. BloomSouth Flooring Corp.*, 562 F.3d 339, 407-408 (1st Cir. 2009); *Burlington Ins. Co. v. PMI Am., Inc.*, 862 F.Supp.2d 719, 740 (S.D. Ohio 2012); *Action Auto Stores, Inc. v. United Capitol Ins. Co.*, 845 F.Supp. 417, 419 (W.D. Mich. 1993); *Standard Fire Ins. Co. v. Chester-O'Donley & Assocs., Inc.*, 972 S.W.2d 1, 10 (Tenn. Ct. App. 1998). Accordingly, this Court should answer the fourth certified question in the negative.

> In *Martco Ltd. P'ship*, the court said:
>
> > [F]or the exclusion to apply, the complaint must unambiguously state that "impaired property" is susceptible to full restoration by repairing, replacing, adjusting, or removing the insured's "work" or the insured's "product." Stated another way, [the insurer] must show that the degradation alleged…would be entirely repaired by simply fixing (or removing) the [insured's product]. Nothing in the complaint unambiguously demonstrates such a simple solution would repair Martco's infrastructure…. Accordingly, we find that the property damage to "the infrastructure" as alleged in Paragraph 12 did not involve "impaired property," and, as such, Exclusion (m) does not apply.

Martco Ltd. P'ship, 588 F.3d at 876-77.

Following the reasoning of *Martco Ltd. P'ship*, the Southern District of Ohio in *Burlington Ins. Co.* rejected arguments by Liberty Mutual and other insurers that the "impaired property" exclusion precluded coverage where a kiln was damaged in areas outside of those on which the insured performed welding work, such that the kiln could not have been fully repaired or fully restored by the insured's repairing, replacing or removing its work. *Burlington Ins. Co.*, 862 F.Supp.2d at 740.

In *Standard Fire Ins. Co.*, the court analyzed the history of the "impaired property" exclusion in evaluating a policyholder's claim seeking coverage for the costs of repairing and replacing a defective HVAC system it had installed in a building. In holding that the "impaired property" exclusion did not preclude coverage, the Tennessee Court of Appeals reasoned:

> The effect of the "impaired property" exclusion is to bar coverage for loss of use claims (1) when the loss was caused solely by the insured's failure to provide work of the quality or performance capabilities caused for by the contract and (2) when there has been no physical injury to property other than the insured's work itself. ***The exclusion does not apply*** if there is damage to property other than the insured's work, or ***if the insured's work cannot be repaired or replaced without causing physical injury to other property.***

Standard Fire Ins. Co., 972 S.W.2d at 10 (emphasis added).

Similarly, in *Essex Ins. Co.*, the court found that the complainant's property could not be "restored to use" simply by repairing, replacing, adjusting or removing the insured's product because the plaintiff alleged that it had to install

carbon air filters to eliminate the odor caused by the insured's defective carpet, and bead blast the floor beneath the carpet. *Essex Ins. Co.*, 562 F.3d at 407-409. As the First Circuit explained:

> A fair reading of [plaintiff's] complaint suggests the property could *not* be restored to use simply by repairing, replacing, adjusting, or removing [the insured's] product or work. The allegations thus fall outside the definition of impaired property. [Plaintiff's] complaint states in relevant part, "as a result of the [insured's] negligent and defective work and materials, and in order to eliminate the alleged odor ... Suffolk expended monies in attempting to remediate the alleged odor ... including ... *the installation of carbon air filters to the ventilation system in the building.*" (emphasis added).
>
> Admittedly, there is no express indication in the complaint that the installation of the air filters actually restored the property to use. On the other hand, neither is there any indication that repairing, replacing, adjusting, or removing the [insured's] defective product (the carpet) restored the property to use. The closest the complaint comes to using such language is in the allegation that reads, "[Plaintiff] was ultimately required to pay BFDS for removal of the existing carpet ... and adhesives, bead-blasting of the concrete floor and replacement of the carpet [ ] and related materials." But even this language indicates that "bead-blasting," a remedial effort that may be distinct from removal and replacement of the carpet, was necessary to restore the property to use. A legitimate reading of the complaint is that Suffolk attempted to remediate the alleged injury (odor) by installing carbon air filters and bead-blasting the concrete floor.

Essex Ins. Co., 562 F.3d at 408-09. These authorities correctly observed that the "impaired property" exclusion has no application when property other than the insured's product has to be replaced in order to restore the damaged property to use.

Moreover, insurance industry commentators concur with these courts' interpretation of the "impaired property" exclusion. As noted in a publication affiliated with the Fire Casualty & Surety Bulletins published by the National Underwriter Co., the "impaired property" exclusion does not apply where the property cannot be restored to use without damaging it during the course of replacing the insured's defective product incorporated into the property. *See* Eugene F. Wolters, *The FC&S Answer: "Impaired Property" CGL Definition Can Prove To Be Tricky*, Nat'l Underwriter P&C, Oct. 26, 1992, at 25 (herein, the "FC&S Article").

The FC&S article raises a hypothetical situation where a manufacturer's defective clasps are attached to purses such that they cannot be removed without damaging the pursues themselves. The author of the FC&S article concluded that the "impaired property" exclusion does not preclude coverage in this instance:

> However, "impaired property" is defined to mean tangible property (but not the insured's product and not the insured's work) that is known to be deficient *if the property can be restored to use* by the removal of the insured's product. In fact, it is impossible to take the defective clasps off without damaging the claimant's purses.
>
> Rather than being "impaired property," the purses are property belonging to another that has been damaged by having the insured's defective product attached. Removal of the defective product will not restore them to their original condition.

Id. This analysis employed by the aforementioned courts and commentators confirms that the "impaired property" exclusion does not apply where the insured's

defective product is irreversibly attached or incorporated to another's property and such property cannot be restored to use without replacing the insured's defective product.

Another insurance industry commentator has conceded that the "impaired property" exclusion may not be applicable where the third party property at issue cannot be restored to use without incurring significant damage to effect replacement of a defective incorporated product:

> When a product, while retaining its separate character, is incorporated into other property in such a way that its removal or alteration would make necessary the destruction of that other property, ***the applicability of the ["impaired property"] exclusion is less clear***.

See Commercial Liability Annotated CGL Policy, *Commercial Liability Insurance*, at V.C.51 (International Risk Management Institute, Supp. 2007) (emphasis added). This commentator's concession that the "impaired property" exclusion cannot be applied clearly or freely from doubt under such circumstances requires this Court, consistent with well-settled rules of insurance policy construction, to strictly construe this exclusion against the insurer in liberally in favor of coverage for the policyholder. *See Evanston Ins. Co. v. ATOFINA Petrochemicals, Inc.*, 256 S.W.3d 660, 668 (Tex. 2008) (an intent to exclude coverage must be expressed in clear and unambiguous language); *Continental Cas. Co. v. Warren*, 254 S.W.2d 762, 763 (Tex. 1953) ("exceptions and words of limitation will be ***strictly construed against the insurer***") (emphasis added).

Thus, this Court should answer the fourth certified question in the negative and find that "replacement" of the insured's defective product irreversibly attached to a third party's product does not include the removal or destruction of the third party's product.

V. CONCLUSION

United Policyholders respectfully submits that this Court should answer the first certified question in the affirmative and strictly construe the "impaired property" exclusion in favor of coverage for the policyholder. United Policyholders further submits that this Court should answer the third certified question by finding that "physical injury" occurs to the third party's product that is irreversibly attached to the insured's product at the moment of incorporation. Finally, United Policyholders respectfully submits that this Court should answer the fourth certified question by finding that that "replacement" of the insured's defective product irreversibly attached to a third party's product does not include the removal or destruction of the third party's product.

Dated: June 22, 2015

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CERTIFICATE OF COMPLIANCE

I hereby certify that, in compliance with T.R.A.P. 9.4(e), this brief has been prepared in a conventional typeface no smaller than 14- point for text and 12-point for footnotes.

I also certify that, in compliance with T.R.A.P. 9.4(i), that the number of words in this brief (excluding any caption, identify of parties and counsel, statement regarding oral argument, table to contents, index of authorities, statement of the case, statement of issues presented, statement of jurisdiction, statement of procedural history, signature, proof of service, certification and certificate of compliance) is 7,304.

Dated: June 22, 2015

By: /s/ Jennifer J. Dotson
Jennifer J. Dotson

CERTIFICATION OF SERVICE

I hereby certify that on June 22, 2015 a true and correct copy of the foregoing BRIEF OF *AMICUS CURIAE* UNITED POLICYHOLDERS IN SUPPORT OF APPELLANT was sent to the following counsel via prepaid first class mail:

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