Key Insurance Coverage Decisions Affecting Businesses in 2017

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Although insurance coverage is to be determined by the language of the policy at issue, court decisions addressing standard policy language can, and do, affect whether or not an insurance company will cover a claim. Throughout 2016, Wisconsin courts issued a number of decisions that may have wide-ranging impact on the interpretation of insurance policies moving forward.

As summarized below, the Wisconsin Supreme Court's 2016 decisions have the potential for **negatively impacting coverage for policyholders**. In a decision that may affect the **interpretation of liability policies** held by most Wisconsin manufacturers and suppliers, the Wisconsin Supreme Court addressed whether or not a defective component (an ingredient in a pill) caused "property damage" to property other than the component itself (the pill) such that coverage would be triggered. The Court found that there was no coverage because the pill was an integrated system. In a separate case, a Wisconsin federal court then interpreted that decision to find there was no coverage for damages caused by a product to surrounding property (a leaky window causing damage to other building elements), where coverage had previously been found under the same set of facts. The Wisconsin Supreme Court also issued two decisions clarifying the **"four corners"** rule, which determines whether or not an insurer has a duty to defend when claims are made against its policyholder. **These two decisions will be key in future cases where a defense is denied by an insurer.** The Court also addressed multiple issues relating to the interplay between two primary policies where the policyholder has a large self-insured retention. Businesses with such large self-insured retentions should take notice of that case and its implications. The Court also addressed the interplay between a builder's risk policy and a homeowner's policy. All of these decisions serve as a reminder that policyholders should periodically review their policies to ensure those policies continue to provide needed coverage and to enlist coverage counsel to challenge any denial of coverage.

- **Wisconsin Supreme Court applied new approach to determine whether or not a defective product caused covered damage to 'other property.'**

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Commercial general liability (CGL) policies provide coverage for "property damage" caused by an "occurrence." An example of a risk manufacturers typically seek to protect themselves against by purchasing CGL insurance is the risk that their product will be defective and harm other property. Whether or not a defective product has caused "property damage" under the terms of a policy such that coverage is triggered is frequently litigated. The long-standing process used by Wisconsin courts to answer that question is to first determine whether or not there was "property damage" under the terms of the policy's coverage grant, which merely requires a showing that that was some "physical injury to tangible property." Second, the court is to consider whether or not any of the property damage is excluded under the standard "your product" exclusion, which precludes coverage only for the policyholder's own product, such that property damage to things other than the insured's own product will be covered.

On March 1, 2016, a divided Wisconsin Supreme Court issued a decision that departed from the traditional approach in which courts were to evaluate whether there was coverage by focusing on the precise language and definitions in a policy. The Court found that two insurance companies did not have to cover their policyholders for claims made against them that they provided an improper ingredient for incorporation into a health supplement that later had to be destroyed. The court reached that conclusion by looking outside of the policy language. The reasoning for the high court's decision, and its potential expansive application, is very troubling for any policyholder that manufactures any type of product, especially component parts that are incorporated into other products.

In *Wisconsin Pharmacal v. Nebraska Cultures, Inc., et al*, 2016 WI 14, the two policyholder manufacturers/suppliers supplied the wrong ingredient to Wisconsin Pharmacal. Wisconsin Pharmacal subsequently incorporated this errant ingredient into health supplement tablets, which were put into the market for sale. After the incorporation of the wrong ingredient was discovered, Wisconsin Pharmacal recalled, and then destroyed, the tablets. After being sued, the suppliers made claim under their CGL insurance policies and asked that their insurance carriers defend them against the lawsuit.

The suppliers' CGL policies included the standard-form language which provides coverage for "those sums that the insured becomes legally obligated to pay as damages because of bodily injury or property damage" caused by an occurrence. The key issue in the lawsuit was whether or not the damage to the supplement tablets caused by the wrong ingredient was "property damage" under the CGL policies. Although the policies (like other standard CGL policies) stated that they provided coverage for "property damage", defined as "physical damage to tangible property" the Court determined that the meaning of "property damage" in the policy was limited to "damage to property other than to the product itself" or to "other property." Ultimately, the Wisconsin Supreme Court determined that there was no "property damage," thus no coverage under the CGL policies, because the alleged damage was only to the supplement tablet itself. In other words, although the suppliers had supplied only a single ingredient, the Court

found that the entire supplement tablet was to be deemed the product of the suppliers.

In reaching its conclusion, the Court, for the first time, applied an "integrated systems rule" in a case addressing insurance coverage issues. In an "integrated system," a defective component (such as the suppliers' ingredient) is considered part of the product as a whole (i.e., the finished supplement tablet). In other words, damage to any part of an "integrated system" is treated as damage to the product itself rather than to "other property." Traditionally, if the supplier's ingredient caused damage to anything *other* than the supplier's own product or ingredient, the supplier's CGL policy provided coverage for those damages. The decision in *Wisconsin Pharmacal* appears to have modified this rule, at least in cases where the product or ingredient could not be separated out from other ingredients. The Court found that "Pharmacal could not separate out the [errant ingredient] from the other ingredients or the other ingredients from each other" and therefore found that "no damage resulted to property other than the ingredients of the integrated system and the completed product, the tablets." The Court concluded that there was no "property damage" because the incorporation of the defective ingredient into the supplement tablets did not damage other property.

The scope and breadth of the Court's ruling in *Wisconsin Pharmacal* has not yet been widely tested by other courts. One interpretation, advocated by policyholders, is that the ruling should be narrowly applied to its facts and only where the defective component part "cannot be separated" from the other components and courts should otherwise continue to follow longstanding Wisconsin precedent that holds that the language of the policy, including the definition of "property damage" in the coverage grant, and the "your product" exclusion, determines coverage – not some "integrated system" test that appears nowhere in the policy. Insurance companies have already argued that the case should be broadly interpreted such that it would be nearly impossible for a policyholder that manufactures any component part or product that is incorporated into others to obtain coverage where its product causes damage.

- **A Wisconsin federal court, relying on the new Wisconsin Supreme Court decision, found that coverage was not triggered where an allegedly defective product (windows) caused damage to property other than the windows (drywall, stucco and framing).**

The potential problems created for Wisconsin policyholders from the approach used by the Wisconsin Supreme Court in *Wisconsin Pharmacal* is demonstrated by a case decided months thereafter where a federal court found that the historical coverage provided to one Wisconsin manufacturer, under exactly the same policy, was changed by the court's decision.

In that case, a Wisconsin federal court applied the *Wisconsin Pharmacal* decision in the context of a class action dispute involving an allegedly defective product causing damage to property other than the product itself. The plaintiffs alleged that windows manufactured by the defendant were defective, causing the windows to prematurely fail and to leak water into, and thereby damage, other building components. After the window manufacturer was sued, its insurers acknowledged that their CGL policies were triggered because the plaintiff homeowners sought not only damages relating to the repair and replacement of the allegedly defective windows themselves (which is typically excluded from coverage under the "your product" exclusion), but also damages to other parts of their homes caused by the allegedly leaky windows (which is traditionally covered under CGL policies). As a result, the window manufacturer's insurers shared in the costs of defending the lawsuit.

During the course of the lawsuit, but prior to the Wisconsin Supreme Court's decision in *Wisconsin Pharmacal*, the federal court issued a decision confirming that coverage was triggered by the allegations that leaky windows caused damage to parts of the homes other than the windows. However, after the Wisconsin Pharmacal decision was issued, one of the insurers lawsuit took the position that its policy obligations had changed in light of the *Wisconsin Pharmacal* decision and asked the court to reconsider its earlier ruling that damage to other parts of the home would be covered. The federal court reversed its earlier decision and ruled that the very same policies that *did* provide coverage, no longer did and that the insurers no longer had a duty to defend the window manufacturer. The court reasoned that the windows were part of an "integrated system," i.e. the homes in which they were installed and therefore damage to not only the windows themselves, but also any other part of the home, was not covered. In essence, the court found that the "integrated system," i.e. the entire home, qualified as the manufacturer's "product" under the CGL policies. Although the window manufacturer argued that the windows could be separated out from the rest of the house (unlike the ingredient in the supplement tablets at issue in *Wisconsin Pharmacal*) the federal court disagreed. The decision is currently on appeal before the Seventh Circuit.

- **The Wisconsin Supreme Court ruled that policy exclusions can be considered when analyzing the duty to defend.**

Under Wisconsin's "four corners" test, the determination of whether an insurance company has a duty to defend its policyholder is based on only the allegations of the complaint and the language of the insurance policy. If there is any question about coverage, Wisconsin law encourages an insurer to seek a coverage determination from a court, rather than outright denying coverage because outright denying coverage when coverage is later found can have severe consequences to the insurer.

In *Marks v. Houston Casualty Company*, 2016 WI 53, the insurer refused to defend its policyholder in a case where he was alleged to have breached his fiduciary duties as an officer and director. The insurer relied on a policy exclusion in denying coverage. The policyholder sued for coverage, arguing, based on a number of earlier Wisconsin cases, that the duty to defend should be determined solely from the policy's coverage grant, without considering any of the exclusions, especially where an insurer outright denied a defense. The Wisconsin Supreme Court disagreed, finding that an insurer can rely on insurance policy exclusions in defending its decision to deny a defense. The Court found that although the allegations of the complaint against Marks fell within the insuring clause of the policy, a business enterprise exclusion precluded coverage for the claims in the case. Therefore, the Wisconsin Supreme Court found that the insurer had not breached its duty to defend Marks by altogether refusing to defend him, even without obtaining a prior court ruling. The court rejected Marks' argument that an insurer that unilaterally disclaims coverage and its duty to defend will be estopped from using policy exclusions or limiting language to litigate coverage if it is subsequently sued for breach of duty to defend. It held that certain Court of Appeals decisions that suggested to the contrary were "unsound in principle" and "detrimental to coherent and consistency in the law" to the extent "they suggest that exclusions may not be considered in analysis of whether an insurer has breached its duty to defend its insured simply because the insurer declined to defend the lawsuit." Thus, policy exclusions will now be relevant to any duty to defend analysis in Wisconsin.

Although this case is unfavorable to Wisconsin policyholders, the Wisconsin Supreme Court did not disturb the well-settled law that the insurer has the burden to prove that an exclusion applies and that exclusions must be read narrowly and in favor of the insured.

- **Wisconsin Supreme Court ruled that facts outside of the complaint are not relevant to a duty to defend analysis even if those facts would clearly establish coverage.**

In *Water Well Solutions v. Consolidated Insurance Company*, 2016 WI 54, the Wisconsin Supreme Court again addressed the four corners rule. In another split decision, the Court removed any doubt and held that there is no exception to the four corners rule in Wisconsin, choosing to include Wisconsin in the shrinking minority of jurisdictions that do not recognize any exceptions.

In *Water Well*, the underlying complaint alleged that the defendant, Water Well, negligently installed a submersible pump in a municipal water system. The complaint alleged that Water Well was negligent in failing to properly install portions of the pipe. As a result, the well pump rotated and unthreaded from the pipe column, fell to the bottom of the well, and caused damages. Although the insurer conceded that "property damage" had been alleged, it denied a defense, relying on both the "your product" and "your work" exclusions. The policyholder argued that the denial was improper based on undisputed evidence it presented

to the court showing that the work that caused the well pump to fall to the bottom of the well was performed not by it, but by one of its subcontractors, removing it from the "your product" and "your work" exclusions. The Wisconsin Supreme Court refused to consider these facts, finding that it was limited to the policy and to the allegations of the complaint in determining whether or not there was a duty to defend. Accordingly, it found a defense was not triggered. In a sharp dissent, two justices criticized the majority's "form over substance" decision that determines a policyholder's entitlement to a defense based on how the plaintiff's lawyer choses to draft the allegations of a complaint, rather than based on the facts.

- **Wisconsin Supreme Court found that a self-insured retention constitutes "other applicable insurance" under a standard policy provision and defines the obligations of a breaching insurer.**

Often, more than one policy may cover the same loss. In those cases, disputes about which policy "comes first" is resolved by the language in the particular policies involved. In *Burgraff v. Menard*, 2016 WI 11, the Wisconsin Supreme Court addressed the interplay between a typical automobile policy and a corporate CGL policy where the policyholder carried a large self-insured retention (SIR).

In *Burgraff*, the plaintiff was injured when a Menard employee was loading materials into his truck with a forklift. The complaint triggered potential coverage for Menard under both Burgraff's auto policy (because Menard was considered a permissive user of the auto) and under Menard's CGL policy where Menard had a $500,000 SIR, meaning that Menard would be responsible for the first $500,000 of defense costs and damages. The auto policy had limits of $100,000 and provided that if there was "other applicable liability insurance" its share would be "the proportion that our limit of liability bears to the total of all applicable limits." The trial court found that the auto policy would be responsible for one-sixth of any verdict or settlement up to $600,000. The auto insurer then settled with the plaintiff for payment of $40,000 and an agreement that such payment extinguished one-sixth of any liability Menard may be found to owe to the plaintiff. The auto insurer then withdrew from defending the case. Menard itself funded its defense through the trial of the case where the plaintiff was awarded damages of $345,000.

The Wisconsin Supreme Court decided several issues. First, it confirmed that Menard's SIR constituted "other applicable liability insurance" as defined in the auto policy, triggering the provision in the auto policy relating to proportionate sharing. Second, it found that the auto insurer breached its duty to defend by withdrawing the defense without first exhausting its $100,000 policy limits. Third, it found that the auto insurer was responsible to pay any damages caused by its breach. Those damages did not include the full amount of the verdict, but did include the defense costs incurred after it withdrew from the defense. In light of the fact that the auto insurer had not followed Wisconsin procedure for contesting insurance coverage, the Court would not allow the auto insurer to

pursue a claim for equitable contribution against Menard. If the insurer had not breached, Menard would likely have been found to be responsible for its portion of defense costs.

- **Wisconsin Supreme Court found that the mere purchase of homeowner's coverage does not terminate builders' risk coverage.**

Builders' risk policies provide coverage for buildings under construction. Once construction is concluded, a permanent property policy is typically procured to cover any losses. In *Fontana Builders, Inc. v. Assurance Company*, 2016 WI 52, the Wisconsin Supreme Court addressed the interplay between these two types policies in an unusual set of facts where the builder of the home and the intended buyers of the home were related parties. The Wisconsin Supreme Court heard the case after two appeals and two jury trials.

In *Fontana Builders*, a fire destroyed a home and its contents worth more than $1 million. The home and its contents were covered by two policies, a homeowner's policy (purchased by the buyer that had taken temporary occupancy before closing) and a builder's risk policy (purchased by the builder). Both insurers denied coverage, arguing the loss was covered by the other's policy. After the buyer settled with the homeowner's insurer, the builder sued the builders' risk insurer. That insurer argued its policy terminated when the homeowners' policy took effect. The court addressed a provision in the builder's risk policy stating that it terminates "when permanent property insurance applies." At the outset, the Court found that the lower courts had erred by allowing a jury to resolve the dispute over the proper application of the builder's risk policy, finding that it was a question of law for the court. The Court went on to find that, although the buyer had begun to occupy the unfinished home, the fact of their occupation and the fact that they had procured homeowners insurance did not terminate coverage under the builder's risk policy because construction continued and it would be the reasonable expectations of an insured builder that coverage would continue.

Fontana Builders reminds us that policyholders should be careful to evaluate the coverage provided by various policies that might be in place to ensure that, while there may be overlaps in coverage, that there be no gaps.