



Case Alert

Texas Rules Incorporation of Defective Products Is Not Physical Injury, But “Rip and Tear” Damages are Covered

In a recent landmark decision, the Texas Supreme Court held that mere incorporation of defective products into a structure without additional property damage is not covered under a commercial general liability policy. However, “rip and tear” or “get to” damages are covered. *United States Metals, Inc. v. Liberty Mut. Group, Inc.*, No. 14-0753, 2015 Tex. LEXIS 1081 (Tex. 2015).

U.S. Metals, Inc. (U.S. Metals) sold custom-made flanges to ExxonMobil Corp. (Exxon) for Exxon’s use in constructing diesel units at its refineries. The flanges were welded to the diesel units’ piping and were then covered with coating and insulation. Exxon later discovered that some of the flanges had leaked and needed to be replaced in order to avoid the risk of fire and explosion. Such replacement required stripping the insulation, cutting each flange out of its respective pipe and replacing, rewelding, and reinsulating the new flanges. This process delayed Exxon’s operations for several weeks.

Exxon sued U.S. Metals. U.S. Metals settled for \$2.2 million and then sought indemnity from its commercial general liability insurer, Liberty Mutual Group, Inc. The Liberty policy contained the standard ISO Exclusions K (“Your Product”) and M (“Impaired Property”). Exclusion K excludes property damage to U.S. Metals’ product. Exclusion M excludes coverage for property damage to impaired property or property that has not been physically injured arising out of a defective product. Liberty denied coverage under these exclusions, and coverage litigation ensued. U.S. Metals maintained that its liability for Exxon’s replacement costs and downtime damages were covered under the policy.

The Court of Appeals for the Fifth Circuit found that the case turned on two questions of Texas law, neither of which had been directly addressed by the Texas Supreme Court: (1) whether the terms “physical injury” and “replacement” found in the “Your Product” and “Impaired Property” Exclusions are ambiguous; and (2) whether U.S. Metals was nonetheless entitled to damages? The Fifth Circuit certified its questions to the Texas Supreme Court seeking further guidance. The Texas Supreme Court distilled the Fifth Circuit’s certified questions into two essential inquiries. First: did the installation of faulty flanges physically injure the diesel units when the only harm at that point was the risk of leaks? Second: is property restored to use by replacing a faulty component when the property must be altered, damaged, and repaired in the process?



Preliminarily, the Texas Supreme Court looked to the policy’s insuring agreement and reasoned that the “provisions of the standard-form CGL policy . . . obligate[d] Liberty Mutual to ‘pay those sums that [U.S. Metals] becomes legally obligated to pay as damages because of . . . ‘property damage’ to which this insurance applies.”¹ The policy defined “property damage” to mean “[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.”

The Texas Supreme Court found that, under Exclusion K, damages to the flanges themselves were not covered.² Focusing on whether an occurrence existed, the Texas Supreme Court rejected the incorporation doctrine and held that 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 reasoned that “[s]ince a defective product that causes damage is not an occurrence until the damage actually happens, it would be inconsistent to now find that a defective product that does not cause damage is nevertheless an occurrence at the time of incorporation.”

The Court struggled with its decision to some degree, pointedly noting that the result in the case had a “perverse aspect to it” in that “[h]ad Exxon been negligent or reckless—had it not tested the flanges, or had it found the defect but decided to risk the danger of leaks—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 . . . [b]ut because Exxon was careful and cautious, U.S. Metals [was] not entitled to indemnity for the costs of remedying the installation of the faulty flanges.”

The Court then considered whether Exclusion M applied. The Texas Supreme Court held that the diesel units were restored to use by replacing the flanges and were therefore “impaired property” to which Exclusion M applied. The Court rejected U.S. Metals’ argument that the diesel units were not “impaired property” because of the fact that the flanges were welded in and restoring the diesel units to use involved much more than simply removing and replacing the flanges alone. The method of replacement did not matter.

However, the insulation and gaskets destroyed in the repair process were not restored to use; they were replaced. Thus, they were not “impaired property” to which Exclusion M applied and the cost of replacing the same (i.e. “rip and tear” or “get to” damages) was covered by the policy. This fix necessitated injury to tangible property and the injury was unquestionably physical. Thus, repair costs were “property damage” covered by the policy.

Although the Court held that incorporation of a defective product into a structure is not physical injury, its finding of coverage for “rip and tear” damages will now be a critical tool in a Texas policyholder’s toolkit for securing coverage.

For further information or to discuss the ramifications of this case, please contact Phillip Adrian Perez at pap@sdvlaw.com or (203) 287-2118.

1. Interestingly, the Texas Supreme Court considered the terms of the insuring agreement and exclusions to be “convoluted” – commentary that has potentially interesting implications for this and a variety of other coverage disputes.
2. U.S. Metals did not seek to recover the cost of the flanges, but damages to the diesel units into which the flanges were incorporated.