

## Texas Justices' Exxon Ruling Comes With Catch For Insurers

By Jeff Sistrunk

*Law360, Los Angeles (December 7, 2015, 9:27 PM ET)* -- The Texas Supreme Court's ruling Friday that a pipe maker isn't covered for the removal of defective parts in Exxon refinery equipment is a win for insurers, but experts say the court's finding that the policyholder is covered for other components damaged when the shoddy parts were taken out broadens insurers' duty to defend in similar cases.

In a multifaceted opinion answering questions certified from the Fifth Circuit, the state high court held that pipe manufacturer U.S. Metals Inc. isn't entitled to indemnity under its commercial general liability, or CGL, policy with Liberty Mutual Group Inc. for the cost to remove and replace faulty parts it sold to Exxon Mobil Corp. for inclusion in diesel refinery units.

The Texas justices said that the mere installation of the defective U.S. Metals parts into Exxon's units, which refine crude oil into diesel fuel for industrial equipment, didn't constitute "physical injury" under the Liberty policy. Among other things, the CGL policy covers losses due to property damage, which is defined as physical injury to property, as well as loss of the ability to use property that isn't physically injured.

This finding is sure to make insurance companies breathe a sigh of relief, experts say, as it prevents them from paying for losses they would argue they didn't agree to cover — which is not to say attorneys were surprised by the Texas justices' ruling. Ten of 12 state supreme courts that have addressed the issue have held that the installation of defective components into a larger system doesn't cause a physical injury under a CGL policy.

"Texas joined the majority of our sister states in finding that physical injury has to be a definite alteration of a physical sort to the structure or material of the product, not simply a risk of failure," said David White, counsel at Thompson & Knight LLP.

However, the Texas high court's opinion wasn't a complete win for insurers. The justices found that Liberty must cover the cost to replace certain components that were ruined when Exxon had to take out the defective parts provided by U.S. Metals.

Under that part of the ruling, experts say, policyholders in similar cases will be able to secure a defense from their insurers if they allege that other property was destroyed when their defective products were removed and replaced.

"The policyholder would then be covered for its defense costs, and would also get the insurer to the

table at settlement time — no small thing," White said.

The dispute centers on metal flanges U.S. Metals sold to Exxon to be welded into diesel refining units at two of Exxon's oil refineries. Exxon discovered a leak in one of the installed flanges and had to replace all of them as a precaution, according to court papers.

The oil giant filed suit against U.S. Metals over the costs associated with the removal of the flanges, and the parties ultimately settled for about \$2.2 million. Liberty denied U.S. Metals' claim for coverage of the deal, pointing to the policy's "your-product" and "impaired property" exclusions.

The your-product exclusion bars coverage for any losses stemming from damage to U.S. Metals' own products. The impaired property exclusion, meanwhile, precludes coverage for damage to "impaired property" — property that is rendered useless or less useful because it incorporates U.S. Metals' defective products — as long as that property can be restored to use by the removal of the faulty products.

After Liberty disclaimed coverage, U.S. Metals sued the insurer in Texas federal court. The district court granted Liberty's motions for summary judgment based on the two policy exclusions, finding Liberty had no duty to defend, and further, that the insurer had no duty to indemnify U.S. Metals for the settlement sum because Exxon's diesel units were impaired property that could be restored to use by replacing the flanges.

U.S. Metals appealed to the Fifth Circuit, which asked for the Texas Supreme Court's guidance on several legal questions in September 2014, leading to Friday's decision.

According to Neel Lane, partner-in-charge of Akin Gump Strauss Hauer & Feld LLP's San Antonio office, a ruling in the other direction — holding that the incorporation of a defective product equates to physical injury — would have expanded the scope of what a typical CGL policy covers.

"If that had happened, companies would have had to pay more for CGL coverage, or insurers would have carved out an exclusion for defects incorporated into customers' products," he said.

"A CGL policy isn't understood to insure against product liability for a defective product, unless the product actually fails in use and causes harm," Lane added later.

Still, attorneys representing policyholders say that the court's finding could have troubling implications. The Texas Supreme Court itself said that the case has a "perverse aspect" to it: If Exxon had failed to detect the leaks and an explosion ensued, it said, U.S. Metals would have been covered by Liberty because there would have been physical injury to people and property.

"From a public policy standpoint, you could have companies doing the wrong things and potentially allowing an incident to happen that could be avoided," said Stephen Moll, a Reed Smith LLP partner and member of the firm's insurance recovery group. "This decision leaves policyholders with a potentially large area of uninsured exposure."

Moll's colleague, Reed Smith partner Jim Cooper, pointed out that Texas courts have yet to adopt the position taken by some other state courts that policyholders are entitled to insurance coverage for preventative measures taken to reduce the possibility of serious damage.

But while the Texas Supreme Court's physical-injury decision was a blow to policyholders, they did walk away with an important win.

The justices determined that the Liberty policy's impaired property exclusion does not apply to the cost to replace insulation, pipe lining and gaskets that were destroyed during the replacement of U.S. Metals' shoddy flanges. Therefore, Liberty must cover the cost to replace those ancillary components.

Allen Wolff, a shareholder in Anderson Kill PC's New York office, said that U.S. Metals can wield the Texas high court's finding that Liberty must cover it for the replacement of those components to argue for coverage for the cost to remove and replace additional components that were destroyed when the flanges were taken out.

"U.S. Metals is now in a position to say, 'Let's start going down the list of things that weren't our product' and assert to the insurance company that there is coverage for these other things as well, following the same logic articulated by the court," Wolff said.

And, according to experts, this prong of the ruling means an insurer would have to provide a defense if a policyholder claims that the removal of its defective products damaged other property.

"I think there is a silver lining [for policyholders] on the duty-to-defend side of things," Cooper said. "By recognizing that some portion of the loss was in fact covered by the policy, an insurer would be obligated to provide a defense as to all claims, both covered and uncovered."

U.S. Metals is represented by Graig J. Alvarez, Lance R. Bremer and Ryan M. Perdue of Fernelius Alvarez PLLC.

Liberty Mutual is represented by Levon G. Hovnatanian, Bruce E. Ramage and Christopher W. Martin of Martin Disiere Jefferson & Wisdom LLP.

The case is U.S. Metals Inc. v. Liberty Mutual Group Inc., case number 14-0753, in the Supreme Court of the State of Texas.

--Editing by Mark Lebetkin and Philip Shea.