

Stunted-Chicken Ruling Hatches Fight Over Defect Exclusions

By **Jeff Sistrunk**

Law360, Los Angeles (July 15, 2016, 7:29 PM ET) -- A New Jersey appeals court's Thursday ruling that adverse side effects caused by chicken feed additive are covered property damage chips away at precedent long relied upon by insurance carriers in product defect cases, but the court's new test for how an exclusion for impaired property is applied sets up fierce battles between insurers and policyholders, experts say.

In a published decision, a panel of the state Appellate Division held that, contrary to a trial court's conclusions, the stunted growth suffered by chickens that ingested policyholder Phibro Animal Health Corp.'s additive constitute an accidental "occurrence" and "property damage" under Phibro's commercial general liability policy with an American International Group Inc. unit.

Several of Phibro's customers alleged that the additive, which was designed to ward off a parasitic disease, stunted their chickens' growth, resulting in losses in the form of reduced meat output and higher processing costs.

The panel disagreed with the lower court's finding that the New Jersey Supreme Court's 1979 ruling in the case of *Weedo v. Stone-E-Brick* supports the position that claims for breach of contract, without the potential for tort liability, are not occurrences under a CGL policy. According to experts, the appellate panel's decision is the latest in a recent string of rulings diminishing the precedential value of *Weedo*, which involved policy language that is no longer in use.

"*Weedo* has been misinterpreted as stating that any incident involving a policyholder's allegedly faulty products is not covered," said Reed Smith LLP partner Traci Rea. "But New Jersey courts are now trying to put *Weedo* in context."

While the panel found that the side effects of Phibro's additive are property damage caused by an occurrence, it remanded the case so the trial court could gather more evidence to determine whether the policy's "impaired property" exclusion applies. The exclusion bars coverage for property damage if the affected property can feasibly be "restored to use" following the replacement or removal of the policyholder's product.

The panel explained that the impaired property exclusion would apply if the chickens could have been restored to use — that is, brought up to their normal weight — within a "commercially viable" time frame and at "commercially reasonable" cost after the Phibro supplement was removed from their diets.

In crafting the two-part test, the panel treaded into uncharted territory for New Jersey courts, and the new guidance will have a wide-ranging impact on battles between insurers and policyholders over the exclusion, experts say.

"The reasonable time and cost parameters could have broader implications in disputes over this exclusion, since they will add another element to expert witness battles over whether one's property damaged by the insured's work or product can, in fact, be restored to its normal use," said Clark & Foxpartner Michael Savett.

In the case, AIG unit National Union Fire Insurance Co. of Pittsburgh, Pa., issued both a CGL policy and an umbrella policy to Phibro for a period spanning from April 2010 through April 2011.

In fall 2009, Phibro began selling its Aviax II chicken feed additive, which was designed to prevent chickens from developing a parasitic disease known as coccidiosis. The following spring, three of the company's customers reported that Aviax had shielded their chickens from disease but had also stunted the birds' growth, leading to lower meat production, increased feed costs and higher processing costs.

National Union denied Phibro's bid for coverage of the customers' claims for economic losses, prompting Phibro to sue the insurer in New Jersey state court.

In June 2014, the trial court, relying on Weedo, granted National Union's motion for summary judgment, concluding that the Phibro customers' alleged losses were not property damage caused by an accidental occurrence as defined by the policies. Even if coverage existed, the lower court said, the National Union policies' impaired property exclusion would bar Phibro's claim for coverage.

But the Appellate Division panel said the lower court's reliance on Weedo was misguided. The Weedo court did not actually weigh in on what constitutes an occurrence, and that decision interpreted language from a 1973 CGL policy form, the panel noted. Phibro's policy with National Union, on the other hand, was written on a 2007 policy form containing a different definition of an occurrence from the policy at issue in Weedo, according to the opinion.

According to experts, New Jersey courts had for many years accepted Weedo for the proposition that damages stemming from a policyholder's defective product or workmanship are not covered under CGL policies, without taking into account intervening changes in policy language.

However, the tide has begun to turn in favor of policyholders, beginning with an Appellate Division ruling last year in the case of Cypress Point Condominium Association v. Adria Towers LLC, experts say. In that case, which is currently pending before the New Jersey Supreme Court, the appeals court rejected the Weedo decision and ruled that damage to common areas of a condominium complex due to a subcontractor's shoddy window installation was property damage caused by an occurrence.

In the Phibro case, the Appellate Division "doubled down on a broad interpretation of the term 'occurrence,'" Savett said.

"Cypress Point was the linchpin and since that ruling, New Jersey courts have been backing away from what had been a tendency to consider foreseeable consequences of defective work or manufacturing in favor of insurers," he said. "Since Cypress Point, courts have been shying away from Weedo."

In another policyholder-friendly holding, the appellate panel also rebuffed National Union's argument that the Phibro customers' chickens didn't suffer damage because they were still processed and sold for human consumption despite being undersized. The chickens suffered "harm to [their] physical condition" by having their growth hindered by the Phibro additive, the panel said.

"The decision is also notable because it reminds that 'physical damage' doesn't mean only that damage which is obvious and visible, but also includes property that has lost some of its use, value or function," said Sheri Pastor, leader of McCarter & English LLP's insurance coverage group.

Perhaps the most significant aspect of the panel's opinion, though, was its establishment of a test to govern the application of the impaired property exclusion, according to attorneys.

"This is the first time the Appellate Division has spoken in a detailed way about the impaired property exclusion and provided some guideposts about what goes into the analysis," said Lynda Bennett, chair of Lowenstein Sandler LLP's insurance recovery group.

National Union asserted that the exclusion applies to bar coverage for Phibro's claims because, if the chickens had been given more time to grow after they stopped eating Phibro's additive, they would have achieved their expected weight and therefore been "restored to use." Phibro countered that, due to the customers' tight production schedules, there wouldn't have been enough time for the chickens to reach a normal weight.

The appellate panel concluded that "the most sensible reading" of the "restored to use" language in the impaired property exclusion must take into account the cost and commercial feasibility of restoring damaged property to use.

"We decline to construe the phrase more expansively to encompass situations in which it would be exorbitant or commercially unrealistic to return the damaged items to their former or normal condition," Judge Jack M. Sabatino wrote for the panel.

While the Phibro case involves a somewhat unusual set of facts, the panel's new test for the application of the impaired property exclusion will apply with equal force in more common scenarios, such as disputes over coverage for damages attributed to construction defects or poorly made factory equipment, according to experts.

To determine whether the exclusion applies in a given case, courts will likely have to sift through mounds of expert testimony and evidence regarding the economic feasibility of restoring damaged property to use, attorneys say.

"What this opinion tells me as a practitioner is it will be extraordinarily difficult to get summary judgment on the impaired property exclusion," Bennett said. "It will be a battle of the experts."

--Editing by Katherine Rautenberg and Kelly Duncan.