

## **Workshop L**

***Wednesday, November 9, 9:00 a.m.–noon***

# ***THE INCORPORATION DOCTRINE IN 2005***

## **Presented by**

**Jeffrey D. Masters**  
**Partner**  
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For the past several years, contractors have seen their coverage for construction defects change dramatically. These changes have been fueled both by the insurers that write the coverage and the courts that interpret it. Insurers have slowly chipped away at contractors' coverage by adding numerous policy exclusions and placing other restrictions on coverage. The courts have compounded the problem with inconsistent interpretations of coverage, which reduce contractors' confidence in the coverage they believe they have. This two-part session will provide an overview of how both the insurance market and the legal system are responding to the issue of construction defects. See how recent court decisions—including four major state supreme court decisions—come to radically different conclusions with respect to issues such as the definition of "occurrence," the "your work" exclusion, and the business risk doctrine in defective construction cases. Attendees will leave with a better understanding of where the insurance market is on this issue and how to argue for coverage in the event of a coverage dispute.



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**Jeffrey D. Masters**  
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Mr. Masters is one of the presenters for Workshop L, "Coverage for Construction Defects: An Oxymoron in 2005?" on Wednesday morning. He is a partner in the Litigation Department and co-chair of the Development Risk Management Practice Group at Cox, Castle & Nicholson LLP.

He represents developers, homebuilders and lenders in complex insurance coverage, construction defect and real estate litigation matters. He also has extensive experience structuring insurance and risk management legal programs for projects of all sizes.

Mr. Masters is a frequent lecturer for real estate industry groups such as the Building Industry Association (BIA), PCBC, the National Association of Home Builders (NAHB), Urban Land Institute and the International Risk Management Institute (IRMI). He is coauthor of the instructional materials for NAHB's educational course, "Risk Management and Insurance for Building Professionals" (2003). He authored the chapter on "Exculpation, Indemnification and Insurance" in CEB's commercial leasing series practice guide, *Office Leasing: Drafting and Negotiating the Lease*. His articles and commentary on real estate insurance, liability defense and risk management have appeared in the *Wall Street Journal*, the *Los Angeles Times*, the *Los Angeles Business Journal*, *Builder and Developer*, *Multifamily Executive*, *Professional Builder*, *Big Builder*, *California Real Estate Journal*, *The Risk Report*, *Contractual Risk Transfer* (IRMI), and in various publications of the California Continuing Education of the Bar (CEB).

He serves as a member of the California Building Industry Association (CBIA) Construction Dispute Resolution Task Force. He also served as a technical consultant on *Broad Form Property Damage Coverage* (Third Edition) published by IRMI and on *California Liability Insurance Practice: Claims and Litigation* (California Continuing Education of the Bar).

Mr. Masters is a graduate of UCLA School of Law and UCLA Anderson Graduate School of Management.

## ***Notes***

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# THE INCORPORATION DOCTRINE IN 2005

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**Jeffrey D. Masters  
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Does incorporation of a defective product or component into the property of another constitute “property damage” within the meaning of the CGL policy? Under the “incorporation doctrine”, the answer historically has been yes. This paper argues that despite judicial attacks, the incorporation doctrine enjoys continued vitality. It remains a key issue in construction and environmental coverage disputes.

## **Historical Background: The Pre-1973 Definition of Property Damage**

Prior to 1966, the CGL policy form did not include a definition of “property damage”.<sup>1</sup> The 1966 CGL form defines “property damage” as “injury to or destruction of tangible property”.<sup>2</sup>

Under both the pre-1966 CGL and the 1966 CGL, courts generally concluded that incorporation of a defective product or component qualified as “property damage”.<sup>3</sup> As the Ninth Circuit stated in Goodyear Rubber & Supply Co. v. Great American Insurance Co.:

“Under well-settled principles, when one product is integrated into a larger entity and the product proves defective, the damage is considered as damage to the entity to the extent that the market

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<sup>1</sup> Wielinski, Insurance for Defective Construction (International Risk Management Institute, Inc. 2000), at 77.

<sup>2</sup> Eljer Manufacturing Incorporated v. Liberty Mutual Insurance Company (7th Cir. 1992) 972 F.2d 805, 810, cert. den., 507 U.S. 1005, 113 S.Ct. 1646 (1993).

<sup>3</sup> See, e.g., Goodyear Rubber & Supply Co. v. Great American Insurance Co. (9th Cir. 1973) 471 F.2d 1343 (property damage found where defective hatch gaskets were incorporated into a vessel); Geddes & Smith Inc. v. St. Paul-Mercury Indemnity Co. (Cal. 1959) 51 Cal. 2d 558, 334 P.2d 881 (warping and malfunctioning doors damaged homes by incorporation).

value of the entity is reduced by an amount in excess of the value of the defective product.”<sup>4</sup>

### **Eljer I and the 1973 Definition of Property Damage**

The definition of “property damage” was modified in the 1973 CGL policy.

“‘Property damage’ means (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.”<sup>5</sup>

Courts have disagreed on whether incorporation of a defective product or component still constitutes “property damage” under the 1973 CGL.<sup>6</sup> However, the better view finds coverage under the 1973 definition. See Eljer Manufacturing Incorporated, *supra* (“Eljer I”).

In Eljer I, the Seventh Circuit held that installation of a defective plumbing system in residences qualified as physical injury to the larger structure, even as to pipes which had not yet leaked. The Seventh Circuit undertook a detailed analysis of the CGL policy wording and the drafters’ intent. The court concluded that the addition of the word “physical” in the 1973 CGL definition of “property damage” did not impair coverage in incorporation cases where there was “physical touching” of the larger structure.

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<sup>4</sup> Goodyear, 471 F.2d at 1344.

<sup>5</sup> Wielinski at 77.

<sup>6</sup> For cases denying coverage, see, e.g., New Hampshire Insurance Co. v. Vieira (9th Cir. 1991) 930 F.2d 696, 700 (omission of drywall in a structure was not property damage); Wyoming Sawmills, Inc. v. Transportation Insurance Co. (Or. 1978) 578 P.2d 1253, 1256; Federated Mutual Insurance Co. v. Concrete Units, Inc. (Minn. 1985) 363 N.W.2d 751, 756.

Comparing the 1966 definition and the 1973 definition, the court stated:

“ . . . If a manufacturer of construction cranes sold a defective crane which collapsed in front of a restaurant, blocking access to it and thereby impairing the restaurateur’s income, and the restaurateur sued the manufacturer and recovered a judgment, the manufacturer’s liability insurer might not have to pay, because the blocking of access might not be considered an injury to tangible property. . . . To allay doubts on this score by sharpening the aim of the 1966 definition, the insurance industry’s committee charged with updating the Comprehensive General Liability Insurance policy form redid the definition in 1973, producing the two-part definition . . . the second part, which is new, explicitly covers the injury inflicted by our hypothetical crane manufacturer – a ‘loss of use of tangible property which has not been physically injured or destroyed.’ The first part of the new definition is the old definition with ‘physical’ prefixed to ‘injury’ to distinguish the two parts. Both cover injury, but the second part covers injury which is not ‘physical’ because there is no physical touching of the tort victim’s property. . . . There was no intent to curtail liability in a case of physical touching, as where a defective water system is installed in a house.”<sup>7</sup>

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<sup>7</sup> Eljer I at 810.

Other courts, notably the California Court of Appeal, have agreed with Eljer I.<sup>8</sup>

## **Eljer II**

But Eljer I and Armstrong were not the last words on the incorporation doctrine. In Travelers Insurance Co. v. Eljer Manufacturing (Ill. 2001) 757 N.E.2d 481, the Illinois Supreme Court rejected the reasoning and conclusions of Eljer I and applied a “plain meaning” analysis to the policy definition of “property damage”. The court found the definition to be unambiguous; therefore, it was unnecessary to resort to insurance industry drafting history for guidance on its interpretation.<sup>9</sup> The Illinois Supreme Court concluded that the larger structure did not suffer “property damage” at the time of installation of the defective plumbing system. The court stated:

“In sum, this court now finds that, under its plain and ordinary meaning, the term ‘physical injury’ unambiguously connotes damage to tangible property causing an alteration in appearance, shape, color or in other material dimension. We reject the policyholders’ assertions that . . . the very installation of a functional [plumbing] system into a structure constitutes ‘property damage’ . . . The plain language of the policies unambiguously states that the insurable event which gives rise to the insurers’ obligation to provide coverage is the *physical* damage to tangible property. The term ‘physical’ limits the word ‘injury’ in the policies’ definition of ‘property damage’.

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<sup>8</sup> See, e.g., Armstrong World Industries, Inc. v. Aetna Casualty & Surety Co. (Cal. 1996) 45 Cal.App.4th 1, 91-94.

<sup>9</sup> Eljer II, 757 N.E.2d at 496.

We also conclude that under its plain and ordinary meaning, the phrase ‘physical injury’ does not include intangible damage to property, such as economic loss.”<sup>10</sup>

### **The Incorporation Doctrine After Eljer II**

Eljer I and Eljer II have never been reconciled. Rather, courts have applied the two decisions in differing ways as they followed divergent paths since Eljer II. The Illinois courts, for example, have tended to cite Eljer II for the proposition that pure economic loss does not qualify as “property damage”. In State Farm Fire and Casualty Co. v. Tillerson (Ill. 2002) 777 N.E.2d 986, the Illinois Court of Appeal denied a defense to a contractor in a construction defect case. The homeowners alleged that the contractor breached his express and implied warranties to them by “building over a cistern and failing to take the necessary precautions to prevent uneven settling of the soil” beneath a room addition.<sup>11</sup> Citing Eljer II, the court stated:

“In their complaint, the [homeowners] merely seek either the repair or the replacement of defective work or the diminishing value of the home. The [homeowners] seek a recovery for economic loss, not physical injury to tangible property. There is no allegation that Tillerson [the contractor] tortiously injured the [homeowners’] home. No property damage is alleged and coverage is not afforded.”<sup>12</sup>

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<sup>10</sup> Eljer II, 757 N.E.2d at 502. (Emphasis in original.)

<sup>11</sup> Tillerson, 777 N.E.2d at 988.

<sup>12</sup> Tillerson, 777 N.E.2d at 991. Presumably, the outcome in Tillerson would have been different had the claimants alleged tortious injury or damage to their home.

Similarly, in Viking Construction Management, Inc. v. Liberty Mutual Insurance Co. (Ill. 2005) 831 N.E.2d 1, the Illinois Court of Appeal concluded that the underlying complaint did not allege “property damage” in a case involving coverage for a construction manager who was an additional insured under a general contractor’s CGL policy. In Viking, portions of a masonry wall collapsed during the course of construction due to inadequate temporary bracing. The decision is not clear on the exact nature of the damage, but citing Eljer II and Tillerson, the court held that the damages constituted economic losses, not “property damage”.<sup>13</sup>

In F & H Construction v. ITT Hartford Insurance Co., a California appellate court reviewed both Eljer I and Eljer II and elected to follow Eljer II’s approach. The insured in F & H erroneously welded lesser grade steel caps onto driven piles in connection with a construction project. The insured sought coverage for the cost to weld stiffeners onto the pile caps. The California court adopted the “plain meaning” approach of Eljer II and denied coverage, holding that “welding the lower grade pile caps to the driven piles does not constitute physical injury to tangible property where the only injury shown is the welded structure’s failure to perform as intended”.<sup>14</sup>

What is the status of the incorporation doctrine now? There is little question that the rule applies to asbestos-containing materials (“ACM”) and to situations involving other contamination or hazardous materials. Indeed, it has been argued that application of the doctrine is limited to such cases.<sup>15</sup>

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<sup>13</sup> Viking, 831 N.E.2d at 17, 18.

<sup>14</sup> F & H Construction (Cal. 2004) 118 Cal.App.4th 364, 371-372.

<sup>15</sup> Fidelity & Deposit Co. of Maryland v. Hartford Casualty Insurance Co. (D. Kansas 2002) 215 F.Supp.2d 1171, 1181-1182 (“... the court believes that the ‘incorporation theory’ has been limited to the asbestos line of cases . . .”). However, in an unpublished decision, the California Court of Appeal in International Paper Co. v. Agricultural Excess & Surplus Insurance Co., 2001 WL 641781 (Cal. 2001) rejected the notion that the incorporation doctrine applies only to cases involving inherently hazardous materials such as ACM. 2001 WL 641781, \*15, 16. See also National Union Fire Insurance Co. of Pittsburgh, PA v. Terra Industries, Inc. (N.D. Iowa 2002) 216 F.Supp.899,

Yet it seems clear that such purported limitations are not valid. Numerous cases afford coverage under an incorporation theory in settings other than those involving ACM or other hazardous materials.<sup>16</sup>

Insureds persuasively may argue that while cases such as Shade Foods recognize incorporation coverage in contamination cases, they do not limit coverage to such cases. Rather, the courts' correct focus has been on the nature and result of the incorporation. Courts can and should continue to find "property damage" where, as in Shade Foods, Newby and other cases, the incorporated product or component is so physically linked with the larger entity that it cannot be removed or removal would damage the larger entity.<sup>17</sup>

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affirmed, 346 F.3d 1160 (8th Cir. 2003), cert. den., 541 U.S. 939, 124 S.Ct. 1697 (2004) (carbonated beverages suffered "property damage" as a result of introduction of benzene-contaminated carbon dioxide); Armstrong, supra (ACM); United States Fidelity & Guaranty Co. v. Wilkin Insulation Co. (Ill. 1991) 578 N.E.2d 926 (ACM).

See also Watts Industries, Inc. v. Zurich American Insurance Co. (Cal. 2004) 121Cal.App.4th 1029 (hazardous products incorporated into municipal water systems raised the possibility of covered property damage to the systems); Shade Foods, Inc. v. Innovative Products Sales & Marketing, Inc. (Cal. 2000) 78 Cal.App.4th 847, 865-866 (wood splinters incorporated into nut clusters).

- <sup>16</sup> See, e.g., Newby International, Inc. v. Nautilus Insurance Co. (6th Cir. 2004) 112 Fed. Appx. 397 (insured supplied defective wood chips containing metal debris for construction of playgrounds); Travelers Insurance Co. v. Penda Corporation (7th Cir. 1992) 974 F.2d 823, 831-833 (yellowing of styrene sheets used in sample books); Imperial Casualty & Indemnity Co. v. High Concrete Structures, Inc. (3rd Cir. 1988) 858 F.2d 128, 134-135 (defective sheet metal used in producing steel washers); Missouri Terrazzo Co. v. Iowa National Mutual Insurance Co. (8th Cir. 1984) 740 F.2d 647, 650 (cracking and deterioration of terrazzo floor); American Motorists Insurance Co. v. Trane Co. (7th Cir. 1983) 718 F.2d 842, 844 (faulty heat exchangers supplied by the insured caused loss of use of natural gas plants).
- <sup>17</sup> Shade Foods, 78 Cal.App.4th at 377 (nut clusters could not be "somehow deconstructed to remove the injurious splinters and then recombined for their original use"); Newby (wood chips and metal debris were raked together); National Union Fire Insurance Company of Pittsburgh, PA v. Terra Industries, Inc., 216 F.Supp. at 916 (contaminated carbon dioxide could not be removed from the beverages into which it had been incorporated; as a result, the entire beverage was rendered unsuitable for human consumption). Note that in an important distinction, the court in Zurich American Insurance Co. v. Cutrale Citrus Juices USA, Inc. (N.D. Fla. 2002) 2002 WL 1433728, emphasized that accidental introduction of an adulterant into the insured's fruit juice, which later was blended with a third party's juice, caused property damage to the third party's blended juice even though the juice did not become unfit for human consumption.

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