INDALEX v. NATIONAL UNION
A CHANGE IN PENNSYLVANIA'S APPROACH TO THE "OCCURRENCE" ISSUE IN PRODUCT AND CONSTRUCTION DEFECT CLAIMS ?

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INDALEX v. NATIONAL UNION - A CHANGE IN PENNSYLVANIA'S APPROACH TO THE "OCCURRENCE" ISSUE IN PRODUCT AND CONSTRUCTION DEFECT CLAIMS ?

In ***Indalex v. National Union Fire Ins. Co. of Pittsburgh***, __ A.3d ___, 2013 WL 6237312 (Dec. 3, 2013) the Superior Court of Pennsylvania issued what may prove to be a significant decision on the subject of liability insurance coverage with respect to faulty workmanship and defective products claims, effectively holding in an apparent departure from past cases that negligence claims involving allegations of damage to property other than an insured's own work or products can involve a covered "occurrence" within the scope of the insuring agreement of a commercial general liability (CGL) policy.

While that holding would not be particularly noteworthy in most jurisdictions, and it is too soon to say whether it will survive either a pending application for reargument (filed December 16, 2013) or a subsequent appeal to the Supreme Court should it be willing to consider the matter , ***Indalex*** may well signal a departure from at least a decade of Pennsylvania case law on the subject, through which our intermediate appellate court has adopted a narrow view of insurance coverage in the context of construction and product defect claims. In several past cases, the Superior Court has held that, because such claims are fundamentally premised upon an insured's breach of contractual obligations, they do not involve a covered "occurrence," regardless of whether they are couched in terms of negligence, or breach of contract, and regardless of whether it is claimed that an insured's defective work or product has caused damage to property other than the insured's own work or product.

It is the court's treatment of claims involving consequential property damage which has set Pennsylvania law apart from that of most other states, and despite acknowledging in several cases that CGL policies are intended to apply where an insured's defective work or product causes accidental injury to other persons or property, the Superior Court has repeatedly held in recent years that there is no covered "occurrence" in such cases, and the federal courts sitting in Pennsylvania have followed suit. *See, e.g.,* ***Freestone v. New England Log Homes,*** 819 A.2d 550 (Pa.Super. 2003), *appeal granted,* 848 A.2d 929 (Pa. 2004), *appeal dismissed*, 2004 Pa. LEXIS 3393; ***PMA Ins. Co. v. L.B. Smith***, 831 A.2d 1178 (Pa.Super. 2003); ***Millers Capital Ins. Co. v. Gambone***, 941 A.2d 706 (Pa.Super. 2007), *appeal denied*, 963 A.2d 471 (Pa. 2008); ***Erie Ins. Exchange v. Abbott Furnace Co.***, 972 A.2d 1232 (Pa.Super. 2009); ***Specialty Surfaces Int'l., Inc. v. Continental Cas. Co.***, 609 F.3d 223 (3d Cir. 2010); ***Nationwide Mut. Ins. Co. v. CPB Int'l., Inc.***, 562 F.3d 591 (3d Cir. 2009).

In order to consider the potential implications of the ***Indalex*** decision, it is necessary to examine the approach which had previously been taken in such cases, and the Superior Court's 2003 decision in ***Freestone*** provides a good example. The plaintiffs in ***Freestone*** allegedly purchased a defective log home kit from the insured, claiming that its defective, unseasoned logs caused expansion and contraction problems, creating gaps which allowed wind and water to enter the plaintiffs' home, both rendering the home uninhabitable, and causing damage to its contents. The Complaint included claims for breach of contract and breach of warranty against

the insured, as well as allegations of negligence in connection with the insured's recommended use of caulk to solve the problems, which allegedly only made matters worse. In concluding that there was no covered "occurrence" despite the plaintiffs' allegations of negligence and their claim of consequential damage to the home's contents, the Superior Court held not only that the breach of contract and warranty claims did not fall within the scope of the insuring agreement, but also that the true "*gist of the action*" with respect to the negligence claim was breach of contract as well, since the seller's negligence was really nothing more than a failure to live up to its contractual obligations. Although the Supreme Court initially granted a discretionary appeal, that appeal was later dismissed.

Another frequently cited Superior Court opinion on the subject is the court's 2007 decision in ***Millers Capital v. Gambone***, involving two class action lawsuits filed by homeowners against a residential real estate developer , claiming damage to both the exteriors and the interiors of their homes due to faulty design, poor workmanship, or construction defects which resulted in water infiltration. In one suit, the plaintiffs claimed that there were defects in the vapor barriers, windows, roofs and stucco exteriors. In the other, the plaintiffs appear to have focused their attention upon the failure of the synthetic stucco. The complaints included claims for breach of contract, breach of warranty, negligence and misrepresentation, among other liability theories. In affirming the entry of summary judgment for the insurer in ***Gambone***, the Superior Court squarely rejected the developer's argument that there was an "occurrence" because the plaintiffs not only alleged a failure of the homes' exteriors, but also claimed ancillary damage to non-defective property inside the homes caused by the resulting water leakage, stating that it could see no legal merit to that distinction. The Supreme Court declined to consider an appeal.

The Superior Court addressed the topic more recently in ***Erie Insurance Exchange v. Abbott Furnace Co.***, 972 A.2d 1232 (Pa.Super. 2009), *appeal denied*, 987 A.2d 161 (Pa. 2009), in which it also held that a plaintiff's claims of consequential damage to personal property which was not part of an insured's work or product were still fundamentally contractual in character, and did not involve a covered "occurrence," again rejecting an insured's attempt to limit the rule to cases in which damage is confined to the insured's own work or product. In ***Abbott***, a furnace manufacturer was sued under theories of breach of contract, breach of warranty , misrepresentation, negligence, and consumer fraud in connection with its delivery of a furnace which did not reach sufficient temperatures to efficiently manufacture the plaintiff's product as promised. In addition to those "inadequate performance" claims, the plaintiff sued for the resulting damage to its products, many of which had to be destroyed and discarded after being placed in the defective furnace due to its malfunctioning, or had to be sold at reduced prices. In rejecting the insured's argument that the claim of consequential damage to the plaintiff's personal property gave rise to a covered "occurrence," the court focused entirely upon what it perceived to be the contractual character of the claim, holding that the *"gist of the action*" was in contract, rather than tort, which in the court's view precluded coverage even for the consequential property damage claims. The Supreme Court again denied further appellate review.

Among the more recent Pennsylvania federal court decisions to the same effect was that of the U.S. Court of Appeals for the Third Circuit in ***Specialty Surfaces International., Inc. v. Continental Cas. Co.***, 609 F.3d 223 (3d Cir. 2010), involving an underlying action for negligence and breach of contract against a manufacturer of allegedly defective synthetic athletic turf in which the plaintiff claimed that the deficient turf caused soil erosion, created depressions and uneven playing surfaces, and resulted in drainage problems beneath its football fields, seeking compensation for those consequential damages in addition to seeking the cost of replacing the turf itself. In upholding the District Court's entry of summary judgment for the insurer, the Court of Appeals rejected the insured's contention that the consequential property damage claims constituted an "occurrence," holding that such an argument was "foreclosed" by the Superior Court's decision in ***Gambone***, in which the same argument with respect to "ancillary damage" had been rejected. Because damage to the subgrade was an entirely foreseeable, if not a predictable result of either the failure to supply a suitable impermeable liner, or to properly install the drainage system, it was held that the resulting damage was not "sufficiently fortuitous" to constitute an "accident" or " occurrence."

Although our Supreme Court has not been totally silent on the subject, it has addressed the "occurrence" issue in the context of defective product or faulty workmanship cases only once in recent years, in the case of ***Kvaerner Metals Div. of Kvaerner U.S., Inc. v. Commercial Union Ins. Co.***, 589 Pa. 317, 908 A.2d 888 (2006). In that case, the Supreme Court held that claims for breach of contract and warranty based upon the insured's poor design and construction of a coke oven battery which failed to satisfy performance specifications did not involve a covered "occurrence".

Although ***Kvaerner*** has since been frequently cited in support of coverage denials in cases involving damage to property other than an insured's own work or product, chiefly for its seemingly categorical pronouncement that claims of faulty workmanship can never be viewed as amounting to an "accident" or "occurrence," that decision did little to clarify the law regarding this issue. In that regard, the underlying claims at issue in ***Kvaerner*** were entirely contractual, it does not appear that there were claims of damage to property other than the insured's product, the Court's opinion referenced, but did not address the merits or approve of the reasoning of several Superior Court authorities such as ***Freestone***, and the Court also cited with approval several cases from other jurisdictions for the proposition that CGL policies are intended to apply where an insured's work or product causes accidental injury to other persons or property, a concept which would seemingly conflict with many of the Superior Court's decisions.

The Supreme Court's refusal to consider appeals in connection with the Superior Court decisions cited previously, as well as several others on the subject, has created a situation in which there has been extensive legal authority providing a reasonable basis for coverage denials in such cases, even where allegations of damage to property other than an insured's own work or products are involved, while at the same time, there has been no clear indication from the Supreme Court as to whether it will ultimately adopt, or reject the Superior Court's approach.

As a result, some insurers have successfully denied liability coverage in such cases while many others have defended such claims pursuant to reservations of rights, quite often ultimately settling the claims while awaiting further guidance from the courts. This has understandably also created friction with policyholders and agents, prompting several insurers to clarify their own more expansive views of coverage by crafting Pennsylvania state-specific policy endorsements, amending their "occurrence" definitions to add language expressly encompassing faulty workmanship claims involving resulting damage to property other than an insured's own work or product.

It is against that backdrop that the Superior Court decided ***Indalex*** in December, holding that an insurer had a duty to defend a window and door manufacturer which was sued by various contractors and homeowners in several states, claiming not only that its products were defective, but that those product defects had resulted in water leakage, causing physical damage to property other than the windows and doors themselves, such as mold and cracked walls, as well as bodily injuries.

In arriving at that conclusion, the court in ***Indalex*** attempted (some might say unpersuasively) to distinguish ***Gambone***, ***Abbott Furnace*** and ***Kvaerner*** (each of which contained categorical statements indicating that claims involving defective products or faulty construction can never be viewed as involving an "occurrence" because they do not involve an "accident") on factual grounds, and in a clear departure from the Superior Court's prior decisions, the panel deciding ***Indalex*** also declined to apply the *"gist of the action"* doctrine to deny coverage with respect to the plaintiffs' negligence claims on the basis that they were fundamentally contractual, even though other panels of the same court had done precisely that in ***Freestone***, ***Abbott Furnace***, and several other cases, noting for the first time that the use of that doctrine had never been approved by our Supreme Court in an insurance coverage context.

Many of us have long anticipated a decision which would either clarify, or mark a turning point in Pennsylvania law with respect to coverage for construction defect claims, and ***Indalex*** has already been cited by several commentators as a significant victory for policyholders, as prohibiting insurers from denying coverage for product defect claims, as stemming the erosion of liability coverage in such cases, as bringing Pennsylvania into line with the law of a majority of jurisdictions, or as amounting to a recognition that our courts had previously gone too far in restricting coverage with respect to claims which would otherwise seem to fall within the intended scope of CGL policies. Others have criticized the opinion, questioning how authoritative it will be given the number of seemingly contrary decisions and pointing to the lack of authority of a Superior Court panel to overrule the prior decisions of other panels.

Whether ***Indalex*** truly heralds a change of direction, or will merely serve to further muddy the waters may well depend upon the outcome of the insurer's pending application for reconsideration or reargument in the Superior Court, or the willingness of the Supreme Court of Pennsylvania to consider an appeal should that application be denied. As has been true for the past several years, it is entirely possible that the Supreme Court will simply decline to review the decision, allowing a state of uncertainty to remain until some future date, when our high court either adopts the Superior Court's more restrictive past approach to coverage in such cases, or

rejects it in favor of the ***Indalex*** decision, claiming in either event that the answer was clear all along.

Andrew Gallogly has been associated with the firm since 1986, and a partner since 1991. Mr. Gallogly devotes much of his practice to insurance coverage opinions, policy drafting, and related litigation, defending insurance agent professional liability claims, representing tour operators, resorts and travel industry service providers in travel related litigation, and handling general liability defense and appellate litigation.