

# The End of *Eljer v. Liberty Mutual*

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Recently, in *Travelers Insurance Co. of Illinois v. Eljer Manufacturing, Inc.*,<sup>1</sup> the Illinois Supreme Court conclusively repudiated a 1992 federal court of appeals decision that has been frequently cited by policyholders seeking to expand insurance coverage. In that case, the Illinois Supreme Court authoritatively laid to rest the viability of *Eljer Manufacturing, Inc. v. Liberty Mutual Insurance Co.*,<sup>2</sup> in which a divided panel of the US Court of Appeals for the Seventh Circuit, in an opinion authored by Judge Richard Posner, effectively rewrote the definition of “property damage” contained in standard-form CGL insurance policies.

In *Eljer v. Liberty*, the Seventh Circuit advanced the so-called incorporation doctrine, holding, purportedly as a matter of Illinois law, that policies providing coverage for “property damage” (defined as physical injury to tangible property) resulting from defective plumbing systems were “triggered” when the plumbing was installed, even if the systems did not leak or cause water damage until many years later. The Illinois Supreme Court expressly rejected this interpretation of Illinois law in *Travelers v. Eljer*, concluding that the policies in question were not “triggered” until the plumbing system actually leaked.

The Illinois Supreme Court’s explicit rejection of *Eljer v. Liberty* is significant because the Seventh Circuit’s decision has been frequently

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1. *Travelers Ins. Co. of Ill. v. Eljer Mfg., Inc.*, 197 Ill.2d 278, 757 N.E.2d 481 (2001).

2. *Eljer Mfg., Inc. v. Liberty Mut. Ins. Co.*, 972 F.2d 805 (7th Cir. 1992), *cert. denied*, 507 U.S. 1005 (1993).

invoked by policyholders, and adopted by some courts, as a way of expanding coverage for claims concerning asbestos, construction defects, Y2K claims, and any other kind of claim involving the integration of one component into a larger whole.

This article discusses the Seventh Circuit's 1992 decision, the manner in which other courts throughout the country have considered the Seventh Circuit's holding, and the conclusive repudiation of the Seventh Circuit's decision by the Illinois Supreme Court. The article concludes with a discussion of reasons for rejecting the *Eljer v. Liberty* holding that the Illinois Supreme Court did not reach in its opinion.<sup>3</sup>

***ELJER V. LIBERTY*—THE SEVENTH CIRCUIT INVOKES  
“FIRST PRINCIPLES” TO OVERRIDE THE ADMITTED  
PLAIN MEANING OF POLICY LANGUAGE**

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Both *Eljer v. Liberty* and *Travelers v. Eljer* involve underlying claims against the same policyholders arising from the same product, the “Qest Quick-Sert II” residential plumbing system manufactured and sold by US Brass Corporation, a wholly-owned subsidiary of Eljer Manufacturing, Inc. and Eljer Industries, Inc. At one point, Eljer estimated that by 1986 the total number of installed Qest systems was 860,000.<sup>4</sup>

In *Eljer v. Liberty*, the policyholders sued only their primary insurance carrier, seeking a declaration as to the “trigger of coverage” for Qest system claims. Subsequently, after the Seventh Circuit issued its “installation trigger” ruling in 1992, the policyholders in 1993 sued their excess insurers, seeking a similar declaration plus other relief. Although the policyholders filed this second suit in federal district court in Chicago, after extended litigation regarding forum issues the litigation between the policyholders and the excess insurers proceeded in Illinois state court.<sup>5</sup>

The insurance policies at issue defined “property damage” as:

- (1) *physical* injury to or destruction of tangible property which occurs

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3. This article does not address the portions of *Eljer v. Liberty* and *Travelers v. Eljer* regarding New York law applicable to certain policies that defined “property damage” as “injury to tangible property” (rather than “physical injury”).

4. The apparent principal cause of the Qest system failures is that certain components degrade when brought into contact with chemicals that are found in ordinary drinking water, resulting in leaks. This erosion apparently occurs slowly, over time. Hence, it is likely that a Qest system installed during the annual effective period of any one insurance policy will not fail, if at all, until years after the expiration of that policy.

5. The “forum battle” between the parties consumed several years and ultimately was resolved by the Seventh Circuit in another decision authored by Judge Posner. See, e.g., *Travelers v. Eljer*, 197 Ill. 2d at 286, 757 N.E.2d at 487–488, citing *In re United States Brass Corp.*, 110 F.3d 1261 (7th Cir. 1997), and *U.S. Brass Corp. v. California Union Ins. Co.*, 198 B.R. 940 (N.D. Ill. 1996). See also *In re United States Brass Corp.*, 173 B.R. 1006 (Bankr. E.D. Tex. 1994).

during the policy period including 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. (Emphasis added).<sup>6</sup>

The policyholders argued that “property damage” took place under this definition when a Qest plumbing system was installed in a home, without regard to whether the system was defective or fully functional at the time of installation or when (if ever) the system leaked, causing water damage to the home and its contents. In other words, the policyholders argued that the applicable “trigger of coverage” for a particular Qest claim was the date the claimant’s system was installed in claimant’s home.<sup>7</sup> In contrast, the insurers argued that, under this definition, no “physical injury” takes place until the system actually leaks and causes water damage, which typically was many years after the system was installed. Under the insurers’ reading of the policy language, only the policies in effect when the system leaked could be “triggered.”

The district judge in *Eljer v. Liberty* adopted the view advanced by the primary insurer.<sup>8</sup> The Seventh Circuit, adopting the policyholders’ view, then reversed.

The Seventh Circuit initially framed the issue as follows:

If a manufacturer sells a defective product or component for installation in the real or personal property of the buyer, but the defect does not cause any tangible change in the buyer’s property until years later, can the installation itself nonetheless be considered a “physical injury” to that property?<sup>9</sup>

The court said the defective product in its hypothetical was like “a time bomb placed in an airplane luggage compartment: Harmless until it explodes. Or like a silicone breast implant that is harmless until it leaks.

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6. See *Eljer v. Liberty*, 972 F.2d at 807; *Travelers v. Eljer*, 197 Ill.2d at 298–299, 757 N.E.2d at 494. The Illinois Supreme Court drew a distinction between these policies (referred to in the court’s opinion as the “post-1981 policies”) and other policies that had been issued to the policyholders before 1982 (referred to by the court as the “pre-1982 policies”), which did not contain the word “physical” in defining “property damage.” See *id.* at 286–287, 757 N.E.2d at 488. The Seventh Circuit decision does not purport to interpret the “pre-1982 policies.”

7. “Trigger of coverage,” of course, is not a term that appears in any of these policies. It is often used, in a colloquial way, as a short-hand expression for issues such as those presented in *Eljer v. Liberty* and *Travelers v. Eljer*: When does “property damage,” as defined in the policies, take place? Although use of the short-hand term is convenient, it should not distract from the fact that determination of the issue depends on application of policy language, not short-hand expressions. See, e.g., *Montrose Chem. Corp. v. Admiral Ins. Co.*, 10 Cal. 4th 645, 655 n.2, 42 Cal. Rptr. 2d 324, 326–327 n.2 (1995).

8. See *Eljer Mfg., Inc. v. Liberty Mut. Ins. Co.*, 773 F. Supp. 1102, 1110–1111 (N.D. Ill. 1991), *rev’d*, 972 F.2d 805 (7th Cir. 1992), *cert. denied*, 507 U.S. 1005 (1993).

9. *Eljer v. Liberty*, 972 F.2d at 807.

Or like a defective pacemaker, which is working fine now, but will stop working in an hour.”<sup>10</sup> The court then asked:

Is the person or property in which the defective product is implanted or installed physically injured at the moment of implantation or installation—in a word, incorporation—or not until the latent harm becomes actual?<sup>11</sup>

In analyzing these issues, the *Eljer v. Liberty* majority opinion started on the wrong foot when it initially expressed the view that the “central issue in the case . . . pivots on a conflict between the connotations of the term ‘physical injury’ and the objective of insurance.”<sup>12</sup> The court acknowledged that “the central meaning of the term [“physical injury”] as it is used in everyday English—the image it would conjure up in the mind of a person unschooled in the subtleties of insurance law—is of a harmful change in appearance, shape, composition, or some other physical dimension of the ‘injured’ person or thing.”<sup>13</sup>

Eschewing the “central meaning” of the term “physical injury” “as it used in ordinary English,” the court declared that “literal” or “ordinary-language” interpretations of words or phrases are not “the only plausible interpretations of contractual language.”<sup>14</sup> The court then incorrectly characterized Illinois law as “unclear.”<sup>15</sup> Consequently, the court considered itself free to analyze the trigger issue as a matter of supposed “first principles” rather than as a matter of policy language or case law.<sup>16</sup>

The *Eljer v. Liberty* majority expressed these “first principles” as follows: “The purpose of insurance is to spread risks and by spreading cancel them. . . . Once a risk becomes a certainty—once the large loss occurs—insurance has no function.”<sup>17</sup> According to the court:

The last point at which a Qest plumbing system has an insurable risk of being defective and causing harm is when it is installed. When it starts to leak it is too late; the risk has turned to a certainty and cannot be spread by being insured.<sup>18</sup>

At the center of the Seventh Circuit’s opinion is its use of this

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10. *Id.*

11. *Id.*

12. *Id.* at 808.

13. *Id.* at 808–809. The court elaborated: “If water leaks from a pipe and discolors a carpet or rots a beam, that is physical injury, perhaps beginning with the earliest sign of rot—the initial contamination. . . .” *Id.* at 809.

14. *Id.* This statement is, of course, directly contrary to accepted principles of contract interpretation. *See, e.g.,* *Outboard Marine Corp. v. Liberty Mut. Ins. Co.*, 154 Ill. 2d 90, 108, 607 N.E.2d 1204, 1212 (1992); *Universal Underwriters Ins. Group v. Allstate Ins. Co.*, 287 Ill.App. 3d 61, 677 N.E.2d 1321 (1st Dist. 1997).

15. *Eljer v. Liberty*, 972 F.2d at 812.

16. *Id.*

17. *Id.* at 809.

18. *Id.*

“risk-spreading” principle to trump the policy language’s requirement of “physical injury” as a prerequisite for finding coverage.

The court asserted that when the “expected failure rate” of a product is “sufficiently high to mark the product as defective,” it made sense, as a way “to induce a rational owner to replace it before it fails,” to “backdate” the injury resulting from the date of failure to the date of installation.<sup>19</sup> The parties in *Eljer v. Liberty* had stipulated that 5 percent of the installed Qest systems would eventually fail and leak. Based on its belief that the stipulated 5 percent failure rate for Qest systems was “sufficiently high to mark the product as defective,”<sup>20</sup> and thus high enough to justify “back-dating,” the court concluded that “property damage” took place, “in the relevant sense,” at “the moment of incorporation—here, the moment when the defective Qest Systems were installed in homes.”<sup>21</sup>

To the extent that the *Eljer v. Liberty* majority considered Illinois law at all, it relied primarily on a single appellate court decision, *Marathon Plastics, Inc. v. International Insurance Co.*,<sup>22</sup> which the Seventh Circuit characterized as “[t]he closest case to ours.”<sup>23</sup> *Marathon* also involved a leaky plumbing system. The system in *Marathon*, however, was not a residential plumbing system, but rather an underground system; thus, the system’s leaks did not cause any physical damage to third-party property, but they did cause the system to become “useless.”<sup>24</sup> The Illinois Appellate Court in *Marathon*, interpreting policies containing the same definition of “property damage” as in the “post-1981 policies” (*i.e.*, “physical injury to tangible property”), ruled that property damage had occurred as the result of the diminution in the value of the plumbing system.<sup>25</sup> The Seventh Circuit majority characterized *Marathon* as an “incorporation trigger” case that was not contradicted by any other Illinois authority.<sup>26</sup> The court therefore relied on *Marathon* as support for its installation trigger.

The *Eljer v. Liberty* majority, however, ignored a number of obvious flaws in the *Marathon* court’s analysis. First, as Judge Cudahy’s dissenting

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19. *Id.* at 812.

20. *Id.*

21. *Id.* at 814. The dissenting opinion, by Judge Cudahy, criticized the majority for its reliance on a product’s failure rate as the basis for the appropriate trigger of coverage. As Judge Cudahy explained:

In this case the Qest System’s failure rate was five percent, so perhaps we could say that each system installed was “defective.” But all products have *some* failure rate. If a product has a failure rate of one percent, or one-tenth of one percent, is it “defective” such that it caused “physical injury” when installed?

*Id.* at 815 (Cudahy, J., dissenting) (emphasis in original).

22. *Marathon Plastics, Inc. v. International Ins. Co.*, 161 Ill.App. 3d 459, 514 N.E.2d 479 (Ill. 1987).

23. *Eljer v. Liberty*, 972 F.2d at 813.

24. *Marathon*, 161 Ill.App. 3d at 462, 514 N.E.2d at 485.

25. *Id.*, 514 N.E.2d at 485.

26. *Eljer v. Liberty*, 972 F.2d at 813.

opinion in *Eljer v. Liberty* correctly recognized, the *Marathon* court “seems to forget that it is applying the new definition” of “property damage.”<sup>27</sup> Although the policies at issue in *Marathon* defined “property damage” as “physical injury to tangible property,” the *Marathon* court erroneously disregarded the policies’ requirement of a “physical injury” and based its holding entirely on cases interpreting a definition of “property damage” that did not contain the word “physical.”<sup>28</sup> This error in *Marathon* is apparent from the fact that the court found that “property damage has occurred” as the result of diminution in value “even though no physical injury occurred to the water system.”<sup>29</sup> This obviously erroneous conclusion was based on the court’s failure to perceive any difference between a definition of “property damage” expressly requiring “physical injury to tangible property” and one merely requiring “injury to tangible property.”<sup>30</sup>

Second, in *Marathon* the failed plumbing system actually leaked. In other words, potential leakage is not what the court considered in finding “property damage,” rather, the court found that property damage had resulted from actual leaks that caused the system to become “useless.”<sup>31</sup> Moreover, *Marathon* did not focus on when property damage took place, because the failed pipe seals leaked during the same policy period in which they were installed. Thus, the *Marathon* court was not confronted with the issue presented in *Eljer v. Liberty*, in which installation and physical injury were widely separated in time.

Moreover, by the time of the Seventh Circuit’s ruling in *Eljer v.*

27. *Id.* at 817 (Cudahy, J., dissenting).

28. See *Marathon*, 161 Ill.App. 3d at 460–464, 514 N.E.2d at 484–486.

29. *Id.* at 463, 514 N.E.2d at 485 (emphasis added).

30. See *id.* at 461, 514 N.E.2d at 484 (stating that the two definitions are “virtually identical”).

Contrary to *Marathon*, it is generally accepted that the addition of the word “physical” to the definition of “property damage” did have the effect of narrowing coverage. See, e.g., B. Ostrager & T. Newman, *Handbook on Insurance Coverage Disputes* (9th ed. 1998), ¶ 7.03[b] at 321 and cases cited therein; *Travelers Indem. Co. of Illinois v. Eljer Indus., Inc.*, 307 Ill. App. 3d 872, 882–883, 718 N.E.2d 1032, 1040 (1999), *aff’d in part and rev’d in part*, 197 Ill.2d 278, 757 N.E.2d 481 (2001), and cases cited therein. Of particular note on this point are *Federated Mut. Ins. Co. v. Concrete Units, Inc.*, 363 N.W.2d 751 (Minn. 1985), and *Wisconsin Label Corp. v. Northbrook Prop. & Cas. Ins. Co.*, 233 Wis. 2d 314, 607 N.W.2d 276 (2000). In both cases, the policyholder pointed to previous rulings: *Hauenstein v. St. Paul Mercury Indem. Co.*, 242 Minn. 354, 65 N.W.2d 122 (1954), and *Sola Basic Indus., Inc. v. United States Fid. & Guar. Co.*, 90 Wis. 2d 641, 280 N.W.2d 211 (1979) in which these same courts had earlier held that diminution in value constituted “property damage.” In both *Federated Mutual* and *Wisconsin Label*, however, the courts distinguished and declined to follow their own previous decisions, pointing out that policy language at issue was different. See, e.g., *Federated Mutual*, 363 N.W.2d at 756 (noting that the revised definition of “property damage”—“physical injury to tangible property”—“differ[s] significantly,” and therefore required a different conclusion from *Hauenstein*, in which the policy defined “property damage” as “injury to tangible property”). The courts in both *Federated Mutual* and *Wisconsin Label* determined that the addition of the word “physical” eliminated the argument that economic injury was covered. See *Federated Mutual*, 363 N.W.2d at 756; *Wisconsin Label*, 233 Wis. 2d at 339, 607 N.W.2d at 288.

31. *Marathon*, 161 Ill. App. 3d at 460–464, 514 N.E.2d at 484–486.

*Liberty* the *Marathon* court's analysis had already been repudiated by another panel of the Illinois Appellate Court in *Bituminous Casualty Corp. v. Gust K. Newberg Construction Co.*<sup>32</sup> In *Bituminous Casualty*, the court held that the installation of a defective heating, ventilation, and air conditioning (HVAC) system in the State of Illinois Center did not constitute "property damage," even if "during the repair work, walls, ceilings and other portions of the building had to be removed and replaced or repaired,"<sup>33</sup> because the installation itself caused "no physical detrimental effect to the State of Illinois Center."<sup>34</sup>

Because its holding was at odds with the clear import of *Bituminous Casualty*, the Seventh Circuit sought to distinguish the case on the basis that it was "not an incorporation case because there was no suggestion that the system could not be removed without damage to the building. . . ."<sup>35</sup> The *Eljer v. Liberty* dissent disagreed, finding it "difficult to imagine that such an HVAC system did not become an integral part of the building at installation."<sup>36</sup> Noting the seeming conflict between *Bituminous Casualty* and *Marathon*, the dissent observed that "*Bituminous Casualty* should ultimately carry the day" because it was the more recent case, it made sense of the Illinois Supreme Court's holding in *Wilkin Insulation*,<sup>37</sup> and the analysis in *Marathon* was of questionable validity.<sup>38</sup>

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32. *Butuminous Cas. Corp. v. Gust K. Newberg Const. Co.*, 218 Ill. App. 3d 956, 578 N.E.2d 1003 (1991).

33. *Id.* at 960–961, 578 N.E.2d at 1006.

34. *Id.* at 966, 578 N.E.2d at 1010. The Seventh Circuit also found support for its "installation trigger" ruling in *Elco Indus., Inc. v. Liberty Mut. Ins. Co.*, 90 Ill. App. 3d 1106, 414 N.E.2d 41 (1980), a case involving defective "governor regulator pins" that were installed in an engine manufactured by a third party. The *Elco* court, however, specifically rejected the argument that the mere installation of the policyholder's improperly fabricated pins constituted property damage. *Id.* at 1111, 414 N.E.2d at 45. Moreover, in citing *Elco* the Seventh Circuit overlooked the fact that the policies at issue in that case did not use the "physical injury" definition of property damage contained in the "post-1981 policies" at issue in both *Eljer v. Liberty* and *Travelers v. Eljer*. See *Elco*, 90 Ill. App. 3d at 1111, 414 N.E.2d at 45.

35. *Eljer v. Liberty*, 972 F.2d at 813.

36. *Id.* at 816 (Cudahy, J., dissenting).

37. *United States Fid. & Guar. Co. v. Wilkin Insulation Co.*, 144 Ill. 2d 64, 578 N.E.2d 926 (1991) ("physical injury" takes place when asbestos-containing materials are installed because that is when, as a factual matter, asbestos contamination coincidentally begins).

38. *Id.* at 816–817 (Cudahy, J., dissenting).

Even before the Illinois Supreme Court explicitly rejected Judge Posner's interpretation of Illinois law and overturned *Marathon* (see notes 97–102, *infra*, and accompanying text), the Illinois Appellate Court and several Illinois trial courts had already refused to follow the Seventh Circuit's decision. In *Diamond State Ins. Co. v. Chester-Jensen Co.*, 243 Ill. App. 3d 471, 611 N.E.2d 1083 (1993), the Appellate Court rejected the analysis of *Marathon*, on which the Seventh Circuit had chiefly relied, on the ground that it was "inconsistent with the clear language and underlying purpose of the policies." *Id.* at 482, 611 N.E.2d at 1091. "If the *Marathon* interpretation were to be adopted . . . the policy would not only provide insurance against tort liability, but would function as a performance bond as well." *Id.*, 611 N.E.2d at 1091. See also *Hoechst Celanese Corp. v. Certain Underwriters at Lloyd's London*, 673 A.2d 164, 168 n.8 (Del. 1996) (noting that "Illinois courts considering insurance coverage for the same plumbing claims have disagreed with the *Eljer* [*v. Liberty*] assessment of Illinois law, and have held that 'leak' is the proper trigger for the underlying claims," and citing two Illinois trial court decisions for support).

Notwithstanding *Marathon's* questionable (if not wholly suspect) value as precedent, the Seventh Circuit maintained that *Marathon* established the existing state of law in Illinois. The court therefore asked whether the Illinois Supreme Court “would not sweep aside the *whole line* of incorporation decisions of the appellate court.”<sup>39</sup> Predictably, in light of the “first principles” proffered at the beginning of its opinion, the Seventh Circuit majority concluded that the Supreme Court would not do so.

### THE *ELJER V. LIBERTY* LEGACY

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The analytical errors contained in the Seventh Circuit’s *Eljer v. Liberty* ruling were compounded as policyholders seized on the decision to support their efforts to expand coverage for claims involving one product or component incorporated into another. Many courts chose to follow the Seventh Circuit’s ruling, thus extending coverage—in contravention of the express definition of “property damage” contained in the policies—to myriad situations in which there had, in fact, not been any “physical injury to tangible property.” Other courts, particularly in asbestos cases, in which property damage took place immediately when asbestos-containing materials were installed into buildings, relied on *Eljer v. Liberty* despite the fact that Judge Posner’s opinion involved an analytically distinct situation in which property damage did *not* take place with installation. In these ways, *Eljer v. Liberty* became woven into the fabric of the common law of insurance, despite its questionable logic and obvious flaws.

#### Acceptance of the *Eljer v. Liberty* Approach

Not surprisingly, members of the policyholder bar embraced *Eljer v. Liberty* and relied on the Seventh Circuit’s opinion to support their efforts to expand coverage. In doing so, these advocates glossed over the opinion’s analytic weaknesses and attempted to characterize *Eljer v. Liberty* as less unusual than even a cursory reading of the opinion would suggest.<sup>40</sup> Central to the arguments pressed by such policyholder lawyers was *Eljer v. Liberty’s* resort to supposed “first principles” to find coverage where none would lie by operation of the unambiguous language of the policies at issue.

One telling example is the treatment of *Eljer v. Liberty* in the

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39. *Eljer v. Liberty*, 972 F.2d at 814 (emphasis added).

40. See, e.g., Jeffrey W. Stempel, *Law of Insurance Coverage Disputes*, Second Edition 14A-47 (2002 Supp.) (“*Eljer* is a bit of a trailblazer . . . but not much of a trailblazer in view of the support it has in case law and commentary”).

policyholder-oriented treatise, *Law of Insurance Coverage Disputes*.<sup>41</sup> Describing *Eljer v. Liberty* as “particularly insightful,” the author concluded that “the *Eljer* holding has much to recommend it.”<sup>42</sup> The author argued that, in order to maximize coverage in instances when a product causes “system-wide injury extending over several years,” it makes sense “to choose a trigger that may involve more insurers because the commercial policyholder is paying for this type of coverage at relatively high rates.”<sup>43</sup> Accordingly, the author urged that the policyholder-manufacturer in such circumstances should be entitled to coverage under policies on the risk at the time of installation of a fully functional product containing a latent potential defect, *and* under subsequent policies on the risk at the time that actual property damage takes place.<sup>44</sup> Seeing no internal contradiction in this approach, the author concluded that “the policyholder is simply asking for the benefit of the policy language where doing so is not at odds with the CGL’s basic purpose.”<sup>45</sup>

Through such arguments, policyholder lawyers touted *Eljer v. Liberty* as a seminal work and vehicle for expanding coverage, while some independent commentators accorded the opinion value as solid precedent.<sup>46</sup> *Eljer v. Liberty* found particular support as a model for maximizing coverage for damages related to the Year 2000 problem and other computer-related losses: Policyholder counsel argued that expenses incurred to prevent Y2K computer failures should be indemnified under policies in effect when allegedly defective software was installed in computer hardware, even though no Y2K-related failures had actually yet taken place.<sup>47</sup>

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41. Stempel, *supra* n.40.

42. *Id.* at 14-53, 14-54.

43. *Id.* at 14A-46 n.80.

44. *Id.* at 14-54.

45. *Id.*

46. *See, e.g.*, Jeffrey W. Stempel, “An Inconsistently Sensitive Mind: Richard Posner’s Cerebration of Insurance Law and Continuing Blind Spots of Economicalism,” 7 *Conn. Ins. L.J.* 7, 37 (2001) (*Eljer v. Liberty* prevents “insurers from engaging in opportunistic cancellation when made aware of manifested plumbing leak problems that present the ticking time bomb to the policyholder-manufacturer”); Scott C. Turner, “Insurance Coverage for Incorporation of Defective Construction Work or Products,” 18 *Constr. Lawyer* 29, 33 (April 1998) (pursuant to *Eljer v. Liberty*, “it is clear that incorporation damages should qualify as damages” under liability policies); Timothy Stanton, “Now You See It, Now You Don’t: Defective Products, the Question of Incorporation and Liability Insurance,” 25 *Loy. U. of Chic. L.J.* 109 (1993) (citing *Eljer v. Liberty* to support the argument that liability insurance policies should be construed to cover defective product incorporation as “property damage”).

47. *See, e.g.*, David R. Cohen and Roberta D. Anderson, “Insurance Coverage for ‘Cyber-Losses,’” 35 *Tort and Ins. L. J.* 891, 906 (2000) (describing *Eljer v. Liberty* as a “leading case” on which policyholders may rely to “support coverage for Y2K remediation, lurking computer viruses, *and other perils that have not yet fully manifested*”) (emphasis added); Mark S. Mayerson, “Insurance Recovery for Year 2000 Losses,” 15 No. 18 *Andrews Computer & Online Indus. Lit. R.* 10 (1998) (citing *Eljer v. Liberty* for the proposition that courts “routinely find” that a policy is triggered when a defective component is incorporated, and that there is no reason to differentiate a defective Qest system from the Y2K problem); Jay W. Eisenhofer, “A Healthy Policy: What Kind of Insurance Does Your Client

But it was mostly in judicial opinions that the *Eljer v. Liberty* ruling came to play all sorts of mischief. Courts grappling with Judge Posner's unique reasoning reached varied, often confusing, and sometimes erroneous results.

Some courts that adopted the *Eljer v. Liberty* approach shared the same analytic mistake of finding property damage in particular policy periods even though no "physical injury" to third-party property had actually taken place as required by the policies at issue. One example is *Newark Insurance Co. v. Acupac Packaging, Inc.*,<sup>48</sup> in which the Appellate Division of the New Jersey Superior Court, relying on *Eljer v. Liberty*, found that coverage existed for the diminution in value of certain advertising cards that had not been physically damaged. The case involved foil laminated pacquettes containing skin cream lotion that were to be glued to advertising cards that were then to be inserted into magazines as part of an advertising campaign. The first pacquettes to be bound into the magazines leaked, however, and had to be removed. The binding process was then halted before all the pacquettes, cards, and lotion were damaged. For various business reasons having to do with product expiration dates and the goals of the advertising campaign, the undamaged cards could not be reused. The skin cream manufacturer and its advertising agency sued the packaging company for, among other things, the cost of the cards (which were the property of the skin cream manufacturer). The packaging company's coverage claim was rejected by its insurer.<sup>49</sup>

The packaging company claimed in a subsequent coverage action that it was entitled to coverage for the cost of those advertising cards that had not been damaged by leaking lotion but which, in the policyholder's view, inevitably would have been damaged if they too had been subjected to the binding process. The policyholder cited *Eljer v. Liberty* in support of its claim for coverage, arguing that "all or a substantial portion of the pacquettes would have leaked onto the cards if subjected to the binding process, rendering the cards inutile for their intended purpose."<sup>50</sup> The court accepted this argument, stating: "We regard *Eljer* [as] persuasive and choose to follow it."<sup>51</sup> The court continued: "We hold that if Acupac [the packaging company] can establish that it was inevitable that all, or a substantial portion, of the cards *would be destroyed* once subjected to the binding process, those cards, which belonged to Revlon [the skin cream

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Company Need Against the Y2K Bug?," *Bus. L. Today* 30 (Oct. 8, 1998) ("Like the situation in *Eljer*, it makes no sense to deny coverage for the costs of Y2K remediation when failure to remediate *will result* in certain, catastrophic loss") (emphasis added).

48. *Newark Ins. Co. v. Acupac Packaging, Inc.*, 328 N.J. Super. 385, 746 A.2d 47 (App. Div. 2000).

49. *Id.* at 388–390, 746 A.2d at 49–50.

50. *Id.* at 400, 746 A.2d at 55.

51. *Id.*

manufacturer], were indeed damaged.”<sup>52</sup> The basis of the court’s ruling was that if the packaging company’s allegations could be proved, “coverage should be afforded because the cards were, *for all intents and purposes*, physically damaged.”<sup>53</sup> Thus, the court found coverage for all of the cards because of presumed future property damage to at least some of them, even though the policy language does not actually afford coverage in such a situation.<sup>54</sup>

Similarly, in *Helm v. Board of County Commissioners*,<sup>55</sup> the Supreme Court of Wyoming cited *Eljer v. Liberty* for the proposition that “[i]t is well recognized that the installation of a defect into a building is physical injury as defined in insurance policies.”<sup>56</sup> Relying on this assertion without any original analysis, the court held that diminution in value to a home caused by defective construction was “property damage” within the meaning of a liability insurance policy. The *Helm* court thus made the same mistake as the Illinois Appellate Court in *Marathon*, which erroneously found that diminution in value constituted a “physical injury.”

Many courts erroneously relied on *Eljer v. Liberty* to decide cases involving products that caused physical injury immediately on incorporation, instances in which Judge Posner’s “backdating” of property damage to the date of installation did not apply. For example, in *Shade Foods v. Innovative Products Sales & Marketing, Inc.*,<sup>57</sup> the California Court of Appeal held that the presence of wood splinters in almonds caused “property damage,” as defined by a cereal company’s insurance policies, when the almonds were incorporated into the cereal company’s products. The court quoted extensively from *Eljer v. Liberty* and stated that “we see no difficulty in finding property damage where a potentially injurious material in a product causes loss to other products with which it is incorporated.”<sup>58</sup> The court held that the presence of the wood splinters in

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52. *Id.* (emphasis added).

53. *Id.*

54. Another decision worth noting is *Hoechst Celanese Corp. v. Certain Underwriters at Lloyd’s London*, 673 A.2d 164 (Del. 1996), in which the Delaware Supreme Court considered the trigger of coverage question under New York law in the context of the same underlying Qest system claims at issue in both *Eljer v. Liberty* and *Travelers v. Eljer*. The *Hoechst Celanese* court relied on *Eljer v. Liberty* in reversing the trial court and concluding that coverage under policies defining “property damage” as “physical injury to tangible property” “may occur as early as installation of the plumbing systems into housing units.” *Id.* at 169. In doing so, the *Hoechst Celanese* court brushed aside a trio of New York law decisions establishing that actual property damage during the policy period is required to trigger coverage. See *Greenlee v. Sherman*, 142 A.D.2d 472, 536 N.Y.S.2d 877 (1989); *Holmes Protection of New York, Inc. v. National Union Fire Ins. Co.*, 152 A.D.2d 496, 543 N.Y.S.2d 459 (1989); *Young v. Insurance Co. of N. Am.*, 870 F.2d 610 (11th Cir. 1989).

55. *Helm v. Board of County Comm’rs*, 989 P.2d 1273 (Wy. 1999).

56. *Id.* at 1276 (emphasis added).

57. *Shade Foods v. Innovative Prods. Sales & Marketing, Inc.*, 78 Cal. App. 4th 847, 93 Cal. Rptr. 2d 364 (2000).

58. *Id.* at 865, 93 Cal. Rptr. 2d at 376–377.

the cereal caused physical injury.<sup>59</sup> *Shade Foods* differed from *Eljer v. Liberty*, however, because the wood splinters immediately contaminated the food product into which they had mistakenly been introduced. Thus, unlike the Qest system at issue in *Eljer v. Liberty*, which generally functioned exactly as intended for a period of years before any leaks took place, actual physical injury in *Shade Foods* took place at the moment the splinters were added to the cereal company's products.

*Eljer v. Liberty* also became a touchstone of written opinions involving asbestos contamination, despite the fact that these cases generally involved allegations that defective asbestos products caused actual physical damage to third party property from the moment of installation, due to the immediate release of asbestos fibers. Thus, the courts in these cases did not need to consider Judge Posner's "incorporation doctrine" at all, as actual property damage took place at the time that asbestos-containing materials were installed into buildings.<sup>60</sup> In *Armstrong World Industries v. Aetna Casualty & Surety Co.*,<sup>61</sup> however, the California Court of Appeal relied on *Eljer v. Liberty* to hold that, when the policyholder's underlying liability resulted from the mere presence of asbestos *without* evidence of contamination from released asbestos fibers, coverage is triggered just by the installation of asbestos-containing materials. Moreover, the court ruled further that, under these circumstances, "incidental" releases of fibers subsequent to installation would *not* trigger insurance coverage—a ruling that would seem to stand on its head the insurance policies' requirement of property damage during the policy period.<sup>62</sup>

As these examples demonstrate, *Eljer v. Liberty* had far-reaching effects and gave policyholders important ammunition in their efforts to expand coverage beyond the boundaries of the language contained in their liability insurance policies.

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59. Curiously, the court relied on *Eljer v. Liberty* without considering, or even acknowledging, the intervening ruling of the Illinois Appellate Court in *Travelers Indem. Co. of Illinois v. Eljer Mfg. Inc.*, 307 Ill. App. 872, 718 N.E.2d 1032 (1999), *aff'd in part and rev'd in part*, 197 Ill. 2d 278, 757 N.E.2d 481 (2001), which had expressly rejected the federal court's statement of Illinois law in *Eljer v. Liberty*.

60. See, e.g., *Maryland Cas. Co. v. W.R. Grace & Co.*, 23 F.3d 617, 627 (2d Cir. 1994) ("actual injury to property—the presence of the asbestos hazard—occurs upon installation"); *Johnson v. Studyvin*, 828 F. Supp. 877, 883 (D.Kan. 1993) ("at the moment when . . . a ceiling texture which is hazardous because it contains asbestos, is attached to some property . . . that property is physically injured").

61. *Armstrong World Indus. v. Aetna Cas. & Sur. Co.*, 45 Cal. App. 4th 1, 52 Cal. Rptr. 2d 690 (1996).

62. *Id.* at 101, 52 Cal. Rptr. 2d at 739.

### Rejection of the *Eljer v. Liberty* Approach

To be sure, many courts emphatically rejected the holding and analysis of *Eljer v. Liberty*. For example, in dismissing a policyholder's arguments urging adoption of the *Eljer v. Liberty* holding, the US Court of Appeals for the First Circuit in *In re San Juan Dupont Plaza Hotel Fire Litigation*<sup>63</sup> invoked Lewis Carroll, the author of *Alice's Adventures in Wonderland*, as follows: "[T]o argue that coverage attaches not when the harm-producing incident occurs but when alleged product defects first become visible, is to construct a pyramidal proposition more reminiscent of Lewis Carroll than of the lexicon of insurance law."<sup>64</sup>

The First Circuit in *San Juan Dupont Plaza* was not the only court to be reminded of Lewis Carroll in considering policyholder arguments urging adoption of the *Eljer v. Liberty* holding. Rejecting the *Eljer v. Liberty* "installation trigger," the court in *Moen v. Allstate Insurance Co.*,<sup>65</sup> another case involving the "trigger of coverage" for plumbing systems, also turned to Lewis Carroll, as follows:

In considering the issues before this Court, I was reminded of a quote from Lewis Carroll from *Alice in Wonderland*. And the quote is "‘He’s in prison now being punished,’ said the White Queen, ‘and the trial doesn’t even begin until next Wednesday; and of course, the crime comes last of all.’ ‘Suppose he never commits the crime,’ said Alice. ‘That would be all the better, wouldn’t it,’ the Queen said."

To place that quote in context and to indicate why I was reminded of it, one has to consider what would happen if in these cases the pb plumbing never leaked. Regardless of the alleged degradation of the pb plumbing, no property damage would result if it didn't leak, no suits would be filed, and no coverage would be afforded without an occurrence.

I think that that, more than anything, indicates that the actual leak is the appropriate trigger under the injury-in-fact trigger type.<sup>66</sup>

In *Hardaway Co. v. U. S. Fire Insurance Co.*,<sup>67</sup> a pipe manufacturer sought coverage under policies that were in effect in 1975, when its pipe was installed, even though the explosion of the pipe that gave rise to the underlying damage claims took place in 1987. Rejecting the policyholder's reliance on *Eljer v. Liberty*, the Florida Court of Appeals held that coverage was triggered by the explosion of the pipeline in 1987, not its installation 12 years earlier. "Because the pipeline failed after the policy

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63. *In re San Juan Dupont Plaza Hotel Fire Litig.*, 989 F.2d 36 (1st Cir. 1993).

64. *Id.* at 38 & n.1.

65. *Moen v. Allstate Ins. Co.*, No. 93 CH 11662 (Ill. Cir. Ct., Cook Cty., Chancery Div.).

66. *Id.*, Transcript of Proceedings, Oct. 23, 1995 (on file with the authors).

67. *Hardaway Co. v. U.S. Fire Ins. Co.*, 724 So. 2d 588 (Fla. App. 1998).

period [of the 1975 policies], there was not an occurrence under the [1975] policies.”<sup>68</sup>

The rejection of the “incorporation theory” underlying the decision in *Eljer v. Liberty* has not been limited to defective plumbing systems. For example, the Wisconsin Supreme Court held in *Wisconsin Label Corp. v. Northbrook Property & Casualty Insurance Co.*<sup>69</sup> that no physical injury to tangible property occurred when erroneous labels were affixed to packages. Accordingly, the court held that liability insurance did not cover losses, such as the cost of relabelling packages, arising from this mislabeling.<sup>70</sup> Similarly, in *Aetna Life & Casualty v. Patrick Industries, Inc.*,<sup>71</sup> the Indiana Court of Appeals found no coverage for the cost of replacing defective particle board because no physical injury to tangible property took place when the defective product was installed. The court reversed a trial court opinion that had relied on *Eljer v. Liberty* and held that the “concept of incorporation should not be extended so that physical injury will be deemed to occur every time a defective component is integrated into another’s tangible property.”<sup>72</sup>

Just three days before the Illinois Supreme Court’s decision in *Travelers v. Eljer*, the US Court of Appeals for the Eighth Circuit in *Esicorp, Inc. v. Liberty Mutual Insurance Co.*<sup>73</sup> held, as a matter of Missouri law, that “property damage” did not occur “unless and until” the incorporation of a defective product causes actual physical injury to tangible property.<sup>74</sup> Rejecting the policyholder’s entreaty to follow *Eljer v. Liberty*, the *Esicorp* court noted that *Eljer v. Liberty*, the “one notable decision” upholding the incorporation doctrine, had been expressly rejected by Illinois state courts.<sup>75</sup>

Finally, it is noteworthy that, in a case not involving insurance

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68. *Id.* at 590. See also *Fireman’s Fund Ins. Co. v. Hartford Fire Ins. Co.*, 73 F.3d 811 (8th Cir. 1996); *Travelers Ins. Co. v. C.J. Gayfer’s & Co.*, 366 So.2d 1199 (Fla. App. 1979). In *Fireman’s Fund*, in which a fire protection system broke and caused water damage, the court held that coverage was potentially available only under those policies that were in effect when the system actually leaked. The court rejected an argument that coverage was available under policies that were in effect earlier, before the leak but during the time gradual deterioration of the system allegedly took place. “[T]he time of the occurrence is not the time the wrongful act was committed but the time the complaining party was actually damaged.” 73 F.3d at 815. The court noted that the “later water damage alone was the relevant injury.” *Id.* (citations omitted). In *C.J. Gayfer’s*, a joint in a roof drainage system failed, discharging water into the claimant’s premises. The policyholder sought coverage under the policy that was in effect when the drainage system was installed. The Florida Court of Appeals found that coverage was not available because that policy had expired before the leak. 366 So. 2d at 1202.

69. *Wisconsin Label Corp. v. Northbrook Prop. & Cas. Ins. Co.*, 233 Wis.2d 314, 607 N.W.2d 276 (2000).

70. *Id.* at 343, 607 N.W.2d at 289.

71. *Aetna Life & Cas. v. Patrick Indus., Inc.*, 645 N.E.2d 656 (Ind. App. 1995).

72. *Id.* at 662.

73. *Esicorp, Inc. v. Liberty Mut. Ins. Co.*, 266 F.3d 859 (8th Cir. 2001).

74. *Id.* at 862.

75. *Id.*

coverage, the Seventh Circuit seemed to retreat from its own reasoning underpinning *Eljer v. Liberty*. The issue in *Fogel v. Zell*<sup>76</sup> was when a claim arose in bankruptcy that related to damages caused by a piping system that burst subsequent to installation. The court ruled that the claim did not arise until the defective piping system actually burst: “The products-liability tort occurs when the defect in design or manufacture causes a harm, and this didn’t happen . . . until the defective pipes burst.”<sup>77</sup> Judge Posner, who wrote the court’s opinion, also recognized that “[i]t is a fundamental principle of tort law that there is no tort without a harm.”<sup>78</sup> Judge Posner did not, however, attempt to reconcile this “fundamental principle” with his conclusion in *Eljer v. Liberty* that there could be “property damage” for insurance coverage purposes before there was an underlying harm.<sup>79</sup>

#### *TRAVELERS V. ELJER: THE ILLINOIS SUPREME COURT’S REPUDIATION OF ELJER V. LIBERTY*

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In a decision issued more than nine years after *Eljer v. Liberty*, the Illinois Supreme Court in *Travelers v. Eljer* thoroughly repudiated *Eljer v. Liberty*. A unanimous court held that “property damage” took place only when a Qest system leaked and caused water damage. The court expressly rejected the “installation” trigger of coverage proffered by the Seventh Circuit’s opinion. The court also held that liability policies do not cover costs incurred for “damage” resulting from the prophylactic replacement of a Qest system that had not leaked. In doing so, the Supreme Court emphatically enforced the plain meaning of the term “physical injury to tangible property” and systematically dismantled the analytic house of cards that the Seventh Circuit had erected nine years earlier.

Of special note, *Travelers v. Eljer* involved excess policies that followed form to the primary policies at issue in *Eljer v. Liberty*. The underlying claims at issue in both cases were the same. Both the Seventh Circuit and the Illinois Supreme Court rendered their rulings under Illinois law. Thus, the Illinois Supreme Court’s unanimous opinion stands as an absolute and conclusive rejection of the “incorporation doctrine” announced in *Eljer v. Liberty*.

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76. *Fogel v. Zell*, 221 F.3d 955 (7th Cir. 2000).

77. *Id.* at 960.

78. *Id.*

79. In another Seventh Circuit opinion, Judge Easterbrook, writing for the majority, seemed to concede that *Eljer v. Liberty*’s days were numbered. See *Great Lakes Dredge & Dock Co. v. City of Chicago*, 260 F.3d 789, 795 (7th Cir. 2001). The court recognized that the *Eljer v. Liberty* and *Travelers v. Eljer* cases were “identical” and that the Illinois Supreme Court would have the last word.

The Illinois Supreme Court concluded that the Seventh Circuit's "interpretation and application of relevant Illinois case law . . . [was] flawed" and that its interpretation of "property damage" would "lead to absurd results."<sup>80</sup> The Supreme Court asserted that the *Eljer v. Liberty* majority erred when it "set aside the 'central,' plain and ordinary meaning of the term 'physical injury,' and instead employed an admittedly 'conjectured' analysis."<sup>81</sup> The court pointed favorably to the reasoning of Judge Cudahy's dissent, and agreed with Judge Cudahy that the *Eljer v. Liberty* majority effectively excluded the word "physical" from the definition of "property damage" contained in the policies.<sup>82</sup>

The *Travelers v. Eljer* court ruled that the phrase "physical injury to tangible property" is unambiguous, and therefore that its usual and ordinary meaning must be applied.<sup>83</sup> Applying the usual and ordinary meaning of "physical injury," the court rejected the policyholders' argument that coverage is triggered when a defective Qest system is installed:

[T]o the average, ordinary person, tangible property suffers a 'physical' injury when the property is altered in appearance, shape, color or in other material dimension. Conversely, to the average mind, tangible property does not experience 'physical' injury if that property suffers intangible damage, such as diminution in value as a result from the failure of a component, such as the Qest System, to function as promised.<sup>84</sup>

According to the Illinois Supreme Court, although an injury may take place at installation of a defective plumbing system, such injury is not physical.<sup>85</sup> The court explained:

[I]f we were to hold that the installation of a fully functional plumbing system constituted 'physical injury to tangible property,' we would effectively eliminate the word 'physical' from the policies' definition of 'property

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80. *Travelers v. Eljer*, 197 Ill.2d at 311–313, 757 N.E.2d at 501–502.

81. *Id.* at 303–304, 757 N.E.2d at 497.

82. *Id.* at 304, 757 N.E.2d at 497.

83. *Id.* at 301, 757 N.E.2d at 496. The court defined the "usual and ordinary meaning" as "that meaning which the particular language conveys to the popular mind, to most people, to the average, ordinary, normal [person], to a reasonable [person], to persons with usual and ordinary understanding, to a business [person], or to a lay [person]." *Id.*, 757 N.E.2d at 496. The court reiterated that, when construing an insurance policy, the primary function of a court is to ascertain and enforce the intentions of the parties as expressed in the contract. If the terms of the policy are clear and unambiguous, "a court must afford them their plain, ordinary, and popular meaning." *Id.*, 757 N.E.2d at 496. This is an emphatic rejection of the Seventh Circuit's approach in *Eljer v. Liberty*, in which the court expressly declined to apply the acknowledged "central meaning of the term as it is used in everyday English." 972 F.2d at 808.

84. *Id.* at 301–302, 757 N.E.2d at 496.

85. *Id.* at 304, 757 N.E.2d at 497, citing *Eljer v. Liberty*, 972 F.2d at 814–815 (Cudahy, J., dissenting).

damage’ and thereby fundamentally alter the terms of the insurance contract entered into between the parties.<sup>86</sup>

The court concluded that, “under its plain and ordinary meaning, the phrase ‘physical injury’ does not include intangible damage to property, such as economic loss . . . the diminution in value of a whole, resulting from the failure of a component to perform as promised, does not constitute a *physical injury*.”<sup>87</sup>

Moreover, the court concluded that allowing policyholders to “back-date” property damage to trigger policies on the risk at the time of installation “would eviscerate another critical term of the policies: the policy period.”<sup>88</sup> Insurance policies do not provide perpetual coverage, and absent “the ability to define and limit contractual risks, insurers cannot effectively spread those risks and contain the costs of insurance.”<sup>89</sup>

The court found that to interpret the policies as affording coverage at installation of a fully functioning Qest system would cause the policies to function as performance bonds.<sup>90</sup> Liability policies, however, are not intended “to pay the costs associated with repairing or replacing the insured’s defective work and products, which are purely economic losses.”<sup>91</sup> Accordingly, the court held that damages related to the voluntary replacement of a fully operational Qest system prior to a leak do not result from a “physical injury to tangible property.”<sup>92</sup> The “injury” caused by the *Qest system* under these facts flows from the claimant’s disappointed commercial expectations in the performance of the Qest system and is not an injury which is ‘physical’ in nature.<sup>93</sup> As the court explained:

Consistent with the policy language agreed upon by the parties to the insurance contract, the insurers did not consent to become guarantors of the product quality or the performance of the Qest systems.<sup>94</sup>

Thus, absent water damage caused by a leaking Qest system, no physical injury took place that could give rise to a covered loss where homeowners replaced fully functioning Qest systems.

In its opinion, the *Travelers v. Eljer* court carefully reviewed the *Eljer v. Liberty* majority’s analysis of Illinois law and found it to be “flawed.”<sup>95</sup>

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86. *Id.* at 313, 757 N.E.2d at 502.

87. *Id.* at 312, 757 N.E.2d at 502 (emphasis in original).

88. *Id.* at 313, 757 N.E.2d at 502–503.

89. *Id.*, 757 N.E.2d at 503.

90. *Id.* at 314, 757 N.E.2d at 503.

91. *Id.*, 757 N.E.2d at 503, quoting *Qualls v. County Mut. Ins. Co.*, 123 Ill. App. 3d 831, 462 N.E.2d 1288 (1984).

92. *Id.* at 315–316, 757 N.E.2d at 504.

93. *Id.* at 316, 757 N.E.2d at 504 (emphasis in original).

94. *Id.*, 757 N.E.2d at 504.

95. *Id.* at 311, 757 N.E.2d at 501.

The Supreme Court ruled that the Seventh Circuit's reliance on *Marathon* was "misplaced."<sup>96</sup> In particular, the court held that the *Marathon* opinion "improperly disregarded the policies' requirement of *physical* injury, explicitly stating that insurance coverage was triggered even though no physical injury occurred."<sup>97</sup> Because the *Marathon* opinion's reasoning was obviously incorrect, the Illinois Supreme Court expressly overruled the decision.<sup>98</sup>

The Illinois Supreme Court also took the *Eljer v. Liberty* majority to task for failing to give appropriate weight to *Bituminous Casualty*, which was decided subsequent to *Marathon* and was particularly significant because it was contrary to *Marathon*. The Supreme Court noted that the Seventh Circuit's assertion that there was "no contrary authority in Illinois" to *Marathon* contradicted the majority's "acknowledgement that the insurers in the *Eljer* case 'placed particular weight' upon a subsequent decision in our appellate court."<sup>99</sup> The court agreed with the dissenting judge in *Eljer v. Liberty* that "*Bituminous Casualty* should ultimately carry the day."<sup>100</sup>

Because an insurer's duty to indemnify only arises when the "insured's activity and resulting loss or damage actually falls within the coverage of the CGL policy," the Supreme Court held that there could not be any duty to indemnify the underlying Qest claims until a leak causing water damage took place.<sup>101</sup> Therefore, the court determined that there was no duty to indemnify when underlying claimants seek damages for diminution in value caused by the mere presence of the Qest system in their homes.<sup>102</sup>

#### ADDITIONAL REASONS FOR REJECTING THE ANALYSIS OF THE SEVENTH CIRCUIT IN *ELJER V. LIBERTY*

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The *Travelers v. Eljer* opinion applied established rules of contract interpretation to the unambiguous policy language at issue. In issuing its ruling, the Illinois Supreme Court did not reach, and did not need to reach, a number of other flawed arguments that policyholders routinely advance in support of the "incorporation" trigger theory. In fact, many additional

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96. *Id.* at 306, 757 N.E.2d at 499.

97. *Id.* at 308, 757 N.E.2d at 500 (emphasis added).

98. *Id.*, 757 N.E.2d at 500.

99. *Id.* at 308–309, 757 N.E.2d at 500.

100. *Id.* at 310, 757 N.E.2d at 501, citing *Eljer v. Liberty*, 972 F.2d at 816 (Cudahy, J., dissenting).

101. *Id.* at 314–315, 757 N.E.2d at 503–504.

102. *Id.*, 757 N.E.2d at 503–504.

compelling reasons exist for finding that the “incorporation” trigger argument cannot be sustained.

First, adoption of the “incorporation” trigger would have the effect of extending coverage beyond “physical injury” to business losses resulting from consumers being disappointed in product quality. *Eljer v. Liberty*’s holding that mere incorporation of a potentially defective product constitutes “physical injury,” even before any “physical injury” actually takes place, frustrates the purpose of liability insurance because it extends coverage to situations in which a consumer replaces a product before it fails, something not contemplated by the parties when the insurance was issued and therefore not included in the premiums charged for liability insurance. Recognizing this principle, the court in *Aetna Life & Casualty v. Patrick Industries, Inc.*,<sup>103</sup> refused to extend coverage to claims arising from the installation of defective particle board, stating that “CGL insurance is not intended to cover, nor will we extend coverage to the type of intangible economic loss that [the policyholder] is seeking.”<sup>104</sup>

Similarly, in *Weedo v. Stone-E-Brick, Inc.*,<sup>105</sup> the New Jersey Supreme Court held that liability policies do not cover the risk of defective products or faulty work, but rather the risk of accidents caused by defective products or faulty work. At issue in *Weedo* was whether “business risk” exclusions contained in liability policies barred coverage for damages caused by defective stucco. The court explained that

[t]he risk intended to be insured [by liability insurance] is the possibility that the goods, products or work of the insured, once relinquished or completed, will cause bodily injury or damage to property other than to the product or completed work itself, and for which the insured may be found liable. . . . The coverage is for tort liability for physical damages to others and not for contractual liability of the insured for economic loss because the product or completed work is not that for which the damaged person bargained.<sup>106</sup>

Thus, as the *Weedo* court and many other courts have recognized, the purpose of liability insurance is not to insure against the commercial risk of making poor quality products.<sup>107</sup> The “incorporation doctrine” would

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103. 645 N.E.2d 656 (Ind. App. 1995).

104. *Id.* at 662.

105. *Weedo v. Stone-E-Brick, Inc.*, 81 N.J. 233, 405 A.2d 788 (N.J. 1979).

106. *Id.* at 240, 405 A.2d at 791.

107. *See, e.g.*, *Commerce Ins. Co. v. Betty Caplette Builders, Inc.*, 420 Mass. 87, 647 N.E.2d 1211 (1995) (damage to home arising from faulty construction not covered by liability insurance); *Dodson v. St. Paul Ins. Co.*, 812 P.2d 372, 378 (Okla. 1991) (refusing to “rewrite” liability policy to provide coverage where none was intended by the parties to the policy); *Western Cas. & Sur. Co. v. Brochu*, 105 Ill. 2d 486, 498, 475 N.E.2d 872, 878 (1985) (liability policy does not cover an “accident of faulty workmanship”); *Peerless Ins. Co. v. Brennon*, 564 A.2d 383 (Me. 1989) (liability policy does not cover defective workmanship); *Seagate Tech., Inc. v. St. Paul Fire & Marine Ins. Co.*, 11 F. Supp.2d 1150

improperly extend coverage to such risks, however, even though they were not reflected in the premiums paid by policyholders for liability insurance.

This is not to say that disappointed consumers are without recourse. They can still seek to recover from the manufacturer or others in the chain of distribution, subject to applicable privity standards, even before property damage has taken place, on theories such as breach of contract or breach of warranty. Giving the term “physical injury” its proper scope means merely that the manufacturer must itself shoulder the cost of such commercial disappointment, rather than foist that cost onto a liability insurer who did not issue a policy covering that particular risk.

Second, a rule that coverage is triggered on the date of installation rather than when the product actually fails and causes property damage would have the perverse effect of reducing the financial incentive of manufacturers to produce and distribute safe, high-quality products. Under such a rule, manufacturers would be insured not only for injuries caused by product failure but also for product recalls and prophylactic repairs and replacements prior to product failure. As the Minnesota Supreme Court has recognized, to allow coverage for mere faulty workmanship, in the absence of actual physical injury, would “present the opportunity or incentive for the insured . . . to be less than optimally diligent in these regards in the performance of his contractual obligations to complete a project in a good workmanlike manner.”<sup>108</sup>

Transforming liability policies into guaranties of product quality would eventually drive up the cost of insurance, which would translate into higher prices for consumers. It would also make liability insurance too costly for some businesses, forcing them to “go bare” (without insurance). That would make it more likely that persons who suffer actual injuries from the widespread failure of products manufactured by such companies would be left without any means of compensation whatsoever. Of course, as the *Eljer v. Liberty* dissent recognized, more expensive specialty policies providing coverage against warranty claims is available for companies who choose to spend the extra money.<sup>109</sup>

Third, the “incorporation doctrine” is directly at odds with the widely recognized rule that, when a cause of “bodily injury” or “property damage” is separated in time from the result of the effect, it is the date of the

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(N.D. Cal. 1998) (extending coverage to installation of a defective disk drive would erroneously convert liability policy into a warranty).

108. *Knutson Constr. Co. v. St. Paul Fire & Marine Ins. Co.*, 396 N.W.2d 229, 234 (Minn. 1986). See also *New Hampshire Ins. Co. v. Vieira*, 930 F.2d 696, 701 (9th Cir. 1991) (allowing coverage for defective drywall installation would encourage defective workmanship).

109. *Eljer v. Liberty*, 972 F.2d at 815 (Cudahy, J., dissenting) (“*Eljer* could have purchased other kinds of insurance that would have covered risks from installation, although we can safely assume that the costs of such insurance would have been higher”).

effect, rather than the date of the antecedent cause, that “triggers” coverage. Thus, coverage is not available under a particular policy if the date of the physical injury is after the policy period, even if the date of an antecedent cause falls within the policy period.<sup>110</sup>

It would stand this rule on its head to permit the mere installation of a potentially defective product to trigger coverage in the year of installation even in the absence of any physical injury during the policy period. The “incorporation doctrine” expounded by the Seventh Circuit majority in *Eljer v. Liberty* boils down to the idea that “property damage” takes place solely by virtue of the installation of a functional component, even when the component does not fail during the policy period and does not cause any physical injury to tangible property during the policy period. This argument has been aptly dismissed as “counterintuitive.”<sup>111</sup>

Fourth, until an installed component actually malfunctions and causes property damage, mere “economic” losses are the *only* losses that it creates. Because such losses do not constitute “physical injury,” it necessarily follows that “property damage” does not take place with installation of a potentially or inherently defective component. The net effect of the “incorporation doctrine” is that coverage can be “triggered,” despite liability policies’ express requirement of “physical injury to tangible property” during the policy period, by “economic losses” such as diminution in value, loss of use, or the cost of replacement (which are the only damages that can even potentially be caused by the installation of a

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110. See, e.g., *State Farm Fire Cas. Co. v. Gwin*, 658 So. 2d 426, 427–428 (Ala. 1995) (under a policy containing a definition of “property damage” requiring physical injury to tangible property, “it is the insurance that is in force at the time of the property damage that is applicable rather than insurance that was in force when the work was performed;” when the alleged tortious act took place during the policy period but the resultant property damage took place after the policy expired, the policy was not triggered); *Owens-Illinois, Inc. v. United Ins. Co.*, 138 N.J. 437, 452, 650 A.2d 974, 981 (1994) (“[T]he time of the occurrence of an accident within the meaning of an indemnity policy is not the time the wrongful act is committed but the time when the complaining party is actually damaged”); *Browder v. USF&G*, 893 P.2d 132, 134 n.2 (Colo. 1995) (“[T]he time of the occurrence of an accident . . . is not the time the wrongful act was committed but the time when the complaining party was actually damaged;” when cracks developed in the building nine years after the contractor’s policy expired, the building owner’s claims against the contractor did not trigger coverage under the policy); *Tacker v. American Family Mut. Ins. Co.*, 530 N.W.2d 674, 676 (Iowa 1995) (“The time of ‘occurrence’ is when the claimant sustains damages, not when the act or omission causing the damage takes place;” when a negligent act caused injury 12 years later, the policy in effect at the time of the injury was the one triggered).

Adoption of an “incorporation” trigger essentially puts in place a regime when coverage is triggered not by actual physical injury but rather by the possibility of future injury. This is, in effect, an “exposure” trigger. Mere exposure to conditions, however, does not usually trigger coverage. See, e.g., *Zurich Ins. Co. v. Raymark Indus., Inc.*, 118 Ill. 2d 23, 44, 514 N.E.2d 150, 159 (Ill. 1987) (“[T]he insurable event which gives rise to the insurer’s obligations . . . is not the exposure to conditions . . .”).

111. *Eljer v. Liberty*, 972 F.2d at 814 (Cudahy, J., dissenting). In full, Judge Cudahy wrote: “There is immediately something counterintuitive about saying that physical injury has been done to a house in which a functioning plumbing system has been installed.” *Id.*

functional component into a larger whole). This nonsensical argument equates “economic loss” with “*physical injury*,” and cannot be squared with the established rule that, when a product that is incorporated into another product is defective, only economic losses are created until the product fails in such a manner as to cause actual physical injury to third-party property.<sup>112</sup>

Fifth, the incorporation doctrine makes it impossible to determine duty-to-defend obligations objectively, thus threatening to multiply litigation and force trial courts to make baseless subjective predictions about future product failure rates. The approach of the majority in *Eljer v. Liberty* is premised on the notion that a product’s failure rate may reach a certain indeterminate level at which the product can be deemed to be so “defective” that the court can justify “backdating” the trigger date for insurance purposes to the product’s installation date. As the dissenting judge in *Eljer v. Liberty* noted, however, “all products have *some* failure rate. If a product has a failure rate of one percent, or one-tenth of one percent, is it ‘defective’ such that it caused ‘physical injury’ when installed?”<sup>113</sup>

More specifically, who knows what the ultimate failure rate will be for any product? How long must one wait to assess that rate, because the failure rate of any product is likely to increase with the passage of time? Given these intractable questions, if the “incorporation doctrine” were law, an insurer asked to defend one or more underlying lawsuits would not be able to tell if its policy had been triggered, because there would be no objective basis for determining whether the court would apply “backdating” to trigger policies based on the date of incorporation rather than the date of alleged “physical injury.” This lack of certainty would inevitably lead to increased litigation over duty to defend issues, with trial judges placed in the difficult position of determining, on a subjective basis, whether a particular alleged failure rate at a specific point in a product’s life cycle could justify “backdating.” These almost metaphysical issues would all be avoided if courts simply applied the policy language and held that coverage was triggered only by actual “physical injury” during the policy period, not by later physical injury “backdated” into earlier policies due to a presumed defective rate.

Sixth, contrary to policyholder arguments, holding that the appropriate trigger is actual property damage rather than mere installation of a potentially defective product does not render liability insurance coverage “illusory.” In the context of Qest plumbing systems, the policyholders

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112. See, e.g., *Moorman Mfg. Co. v. Nat’l Tank Co.*, 91 Ill. 2d 69, 84–85, 435 N.E.2d 443, 450 (1982); *Qualls v. Country Mut. Ins. Co.*, 123 Ill. App. 3d 831, 835, 462 N.E.2d 1288, 1292 (4th Dist. 1984).

113. *Eljer v. Liberty*, 972 F.2d at 815 (Cudahy, J., dissenting) (emphasis in original).

argued that adoption of a leak trigger would cause their coverage to become “illusory” because insurers began specifically excluding coverage for Qest claims in approximately 1986, when a large number of leaks began taking place. Thus, the policyholders argued, failure to apply an “installation” trigger would mean that they would not have sufficient coverage for these claims. To avoid this result, the policyholders argued that an “installation” trigger must apply.

Insurance policy interpretation, however, is based on the language of the policies, not a policyholder’s after-the-fact realization that it did not buy enough coverage for a particular type of loss. A court may not strain to find coverage if it is not provided by the policy language.<sup>114</sup> If the language of policies—requiring that “property damage” take place “during the policy period”—provides less coverage because relatively few Qest systems leaked during certain policy periods, then coverage should not be artificially extended, in contravention of the policy language, to provide the policyholder with coverage it did not purchase.

Moreover, a policy is not “illusory” just because it does not cover a particular claim or series of claims. With regard to the manufacturers of Qest systems, for example, failure to apply an “installation” trigger to Qest claims would not in any way impair such other coverage as may be available for property damage resulting from leaks of Qest systems during the policy period, for other types of property damage claims, and for claims of bodily injury, personal injury, medical injury, and advertising injury.

Finally, rejecting the incorporation doctrine does not *ipso facto* create broad, negative public policy implications for cases involving the installation of defective products. “Construing an insurance contract accurately and giving it the effect which its language clearly commands, is not *ipso facto* a breach of public policy.”<sup>115</sup> Policyholders as well as insurers would

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114. See *Hartford Acc. & Indem. Co. v. Aetna Ins. Co.*, 132 Ill.2d 79, 85, 547 N.E.2d 114, 117 (1989) (“[W]e will not rewrite the parties’ policies [to] . . . impose an obligation where none was undertaken”). See also *State Farm Mut. Auto. Ins. Co. v. Coviello*, 233 F.3d 710, 717 (3d Cir. 2000) (“We are not at liberty to rewrite an insurance contract, or to construe clear and unambiguous language to mean something other than what it says”); *Employers Ins. of Wausau v. Stopher*, 155 F.3d 892, 900 (7th Cir. 1998) (“[W]e may not rewrite the plain and unambiguous language of the insurance contract”); *Adams v. Reliance Standard Life Ins. Co.*, 225 F.3d 1179, 1186 (10th Cir. 2000) (“[C]ourts are not at liberty, under the guide of judicial construction, to rewrite the policy”); *Royal Ins. Co. v. Latin Am. Aviation Serv., Inc.*, 210 F.3d 1348, 1351 (11th Cir. 2000) (“Courts are not free to rewrite an insurance policy or add terms or meaning to it”).

115. *Putnam v. New Amsterdam Cas. Co.*, 48 Ill. 2d 71, 86, 269 N.E.2d 97, 104 (1970). As the Illinois Supreme Court has repeatedly stated, “[p]ublic policy does not require invalidation of clearly written provisions simply to avoid disappointment to the insured.” *Western Cas. & Surety Co. v. Brochu*, 105 Ill. 2d 486, 495, 475 N.E.2d 872, 876 (1985); *Illinois Farmers Ins. Co. v. Cisco*, 178 Ill. 2d 386, 392, 687 N.E.2d 807, 810 (1997). See also *AIU Ins. Co. v. Superior Court*, 51 Cal. 3d 807, 818, 274 Cal Rptr. 820, 829, 799 P.2d 1253, 1262 (1990) (“Because Congress and the Legislature already have made the relevant public policy determinations, the issue before the court is not whether

be harmed if judges were to create coverage where none existed, because that would leave other policyholders “to bear the expense of increased premiums necessitated by the erroneous expansion of their insurers’ potential liabilities.”<sup>116</sup> Moreover, insurance companies too can be driven out of business, which also adversely affects other policyholders.

## CONCLUSION

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*Eljer v. Liberty*’s use of supposed “first principles” to backdate property damage to a time before any physical injury had taken place injected an aberrational decision into the canon of coverage law. Suddenly, the policy term “physical injury” no longer required any physical injury. In subsequent years, policyholders repeatedly cited this ruling in their efforts to expand coverage, resulting in confusing, analytically muddled decisions from courts across the land. In *Travelers v. Eljer*, the Illinois Supreme Court decisively put Judge Posner’s genie back into the bottle, and returned coverage law to the ultimate first principle: That unambiguous policy language cannot casually be brushed aside as an inconvenience, but must be applied as written.

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CGL policies *may* provide coverage sought, but whether they *do* provide it according to their terms. The answer is to be found solely in the language of the policies, not in public policy considerations”); *Patrons Oxford Mut. Ins. Co. v. Marois*, 573 A.2d 16, 17–18 (Me. 1990) (“[O]ur role here is simply to determine the meaning of a private contract between these parties, not to foster or retard environmental goals . . . our discussion focuses on the language of the insurance contract”); *Danbeck v. American Family Mut. Ins. Co.*, 245 Wis.2d 186, 197–198, 629 N.W.2d 150, 156 (2001) (“[P]ublic policy, as important as it is, cannot supercede unambiguous policy language or impose obligations under the contract which otherwise do not exist”).

116. *Garvey v. State Farm Fire & Cas. Co.*, 48 Cal. 3d 395, 408, 257 Cal. Rptr. 292, 770 P.2d 704, 711 (1989).