# Recent Federal Appeals Court Decision on Insurance Coverage Impacts Manufacturers

Article
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**Federal Appeals Court Clarifies that Wisconsin Supreme Court Did Not Intend to Sharply Curtail Coverage for Wisconsin Manufacturers.**

On August 8, 2017, the U.S. Court of Appeals for the Seventh Circuit (the federal court that hears appeals from Wisconsin, Illinois and Indiana federal courts) issued a decision that significantly benefits all Wisconsin manufacturers. In *Haley v. Kolbe & Kolbe Millwork Co., Inc.*, the Seventh Circuit found that a window manufacturer has insurance coverage under a standard commercial general liability (CGL) policy for damages caused by allegedly leaky windows. In *Haley*, the underlying case against the manufacturer for defective windows was dismissed by the court on its merits. However, the insurance companies asserted that they were not responsible to pay the manufacturer's costs to defend the case, arguing that water damage to property surrounding the windows was no longer covered based on a case decided by the Wisconsin Supreme Court in early 2016 that they claimed changed Wisconsin law. The federal court rejected the insurers' arguments and found that coverage for the window manufacturer continued to exist. The decision is a big win for Wisconsin manufacturers because it clarifies that the insurance coverage manufacturers purchased for years to protect their businesses against claims that their product damaged other property remains intact.

**The Wisconsin Supreme Court applies an integrated system approach, denying insurance coverage to a component manufacturer where its product became part of a homogenous end product.**

A standard CGL policy does not generally provide insurance coverage for a policyholder's own product, but it does insure against damage caused by the product to other property. As we reported on February 10, 2017, in *Wisconsin Pharmacal v. Nebraska Cultures*, the Wisconsin Supreme Court applied a new approach to determine whether or not the defective product in that case caused covered damage to other property. On March 1, 2016, a divided Wisconsin Supreme Court found that two insurance companies did not have to cover their policyholders for claims that a product they produced harmed other parts of a


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finished product. The court reached that conclusion by looking outside of the policy language and applying an "integrated systems" test. In that case, the two policyholder manufacturers/suppliers supplied the wrong ingredient which was subsequently incorporated into health supplement tablets. Those tablets were later recalled, and then destroyed. After being sued, the suppliers made claim under their CGL insurance policies and asked their insurance carriers to defend them against the lawsuit because their defective ingredient caused damage to the supplement tablets.

The Wisconsin Supreme Court determined that there was no "property damage," thus no coverage, under the CGL policies. Although the suppliers had supplied only a single ingredient, the Court found that the entire supplement tablet was to be deemed the supplier's product for coverage purposes. In reaching its conclusion, the Court, for the first time, applied an "integrated systems rule" in a case addressing insurance coverage issues. In an "integrated system," a defective component (such as the suppliers' ingredient) is considered part of the product as a whole (i.e., the finished supplement tablet), so that damage to any part of the "integrated system" is treated as damage to the product itself rather than to "other property." The Court found that because the claimant could not separate out the errant ingredient from the other ingredients or the other ingredients from each other, "no damage resulted to property other than the ingredients of the integrated system and the completed product, the tablets." The Court concluded that there was no "property damage" because the incorporation of the defective ingredient into the supplement tablets did not damage other property.

Ever since the *Wisconsin Pharmacal* case was decided, insurance companies have relied heavily on it to try to avoid providing coverage to their policyholders for damage caused by their products. Insurance companies have argued that the case should be broadly interpreted so that it would be nearly impossible for a policyholder that manufactures any component part or product that is incorporated into another product to obtain coverage where its component part damages the finished product. Policyholders have argued that the *Wisconsin Pharmacal* ruling should be narrowly applied to its facts and is only relevant in cases where a defective component part cannot be separated out from the other components or where the finished product as a whole is worthless.

**The federal appellate court clarifies that Wisconsin manufacturers of component parts continue to have coverage if their component harms a finished product.**

In *Haley v. Kolbe*, the federal appeals court discussed the *Wisconsin Pharmacal* decision in a case involving an allegedly defective product causing damage to property other than the product itself. The plaintiffs in that case alleged that windows manufactured by the defendant were defective, causing the windows to prematurely fail and to leak water into, and thereby damage, other building components. Based on *Wisconsin Pharmacal*, the insurance companies argued that the Wisconsin Supreme Court mandated that the integrated system analysis

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be applied in every case and that there was no coverage for damage to other building components because the windows were part of an "integrated system," i.e., the home. Therefore, they argued, any damage to any part of the home was not covered. In essence, they argued that the house was an "integrated system," and therefore, qualified as the manufacturer's "product" under the CGL policies. The window manufacturer argued that the windows could be separated out from the rest of the house (unlike the ingredient in the supplement tablets at issue in *Wisconsin Pharmacal*) and the house was not rendered useless as a result of allegedly leaky windows.

The Seventh Circuit Court of Appeals agreed with the manufacturer. It found that the integrated system test is only to be used in cases where there is a loss of the *entire* integrated system. In *Wisconsin Pharmacal*, the only loss alleged was the plaintiff's inability to use the supplement tablets as a whole. The plaintiff did not seek reimbursement for the cost of repairing or replacing the tablets' non-defective ingredients. The type of claims made by the homeowners against the window manufacturer were much different. The homeowners sought compensation to repair or replace parts of their home that were damaged by water infiltration – they were not claiming that their entire homes were worthless or that the windows could not be removed from their homes.

In sum, the Seventh Circuit clarified that Wisconsin manufacturers continued to have coverage for damages caused by defective components to a finished product. Davis & Kuelthau, s.c., which specializes in representing policyholders against their insurance companies, represented the policyholder in *Haley v. Kolbe*.

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