

REBUTTAL: When Insurance Policies Are Enforced As Written

Law360, New York (January 26, 2016, 11:39 AM ET) --



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Manufacturers of goods face the constant risk of loss caused by hidden defects and production errors. Left undiscovered, such issues can lead to batch-wide product contamination, recalls and even reputational costs. Many manufacturers are opting to protect themselves by purchasing specialized insurance against the risk of such recall-related or food-contamination costs. But when policyholders in the manufacturing industry elect instead to purchase no more than a general “all risks” property insurance policy — which will almost always exclude faulty workmanship/design — they are often left without coverage, and rightly so.

One policyholder, HP Hood LLC, learned this the hard way when the Massachusetts Court of Appeals recently upheld a denial of coverage pursuant to a faulty workmanship/design exclusion for nearly two million faulty beverage products that HP Hood had destroyed. See *HP Hood LLC v. Allianz Global Risks U.S. Insurance Co.*, 39 N.E.3d 769 (Mass. Ct. App. 2015). Following a recent Law360 guest article arguing that the case was decided incorrectly, this article takes the opposite view and explains why the court got it right.

The Facts

The insured is HP Hood, a company that manufactured certain bottled beverage products for a third-party customer. The finished beverage products are supposed to be “shelf stable,” such that the unrefrigerated products do not go bad over time so long as the products remain securely sealed. To ensure that the products are securely sealed, HP Hood must screw the caps onto each bottle using a certain amount of circular force (or “torque”).

Following a 2009 production run of nearly two million products, HP Hood discovered that a significant number of bottles were not sealed securely. Subsequent testing revealed that the problem had to do

with the bottle caps in that their liners became more slippery over time. This affected the amount of torque that HP Hood needed to use to seal the bottles properly. Since the production process HP Hood used for the run at issue did not take into account the particular age of the bottle caps, some caps did not receive optimal torque when the bottles were capped.

HP Hood's customer refused to accept any finished products from the production run at issue, because the products were no longer marketable, even though not all of the nearly two million products had spoiled. HP Hood therefore made the business decision to destroy all of them.

HP Hood then sought coverage for the nearly two million destroyed products under HP Hood's general "all risks" property policy issued by Allianz Global Risks U.S. Insurance Co. Allianz denied coverage in part on the basis of an exclusion for "faulty workmanship, material, construction or design, from any cause." The trial court upheld Allianz's denial of coverage on this, among other, grounds, and HP Hood appealed.[1]

The Court of Appeals Decision

On appeal, HP Hood argued that the faulty workmanship/design exclusion at most precludes coverage only for the bottle caps themselves, and that the loss of the product inside the bottles is covered. HP Hood asserted this argument on the basis of the following exception to the exclusion, commonly referred to as an "ensuing loss" or "resulting loss" provision: "This 'policy' does not cover [faulty workmanship, material, construction or design, from any cause], but if physical loss or damage not otherwise excluded by this 'policy' to insured property at insured location(s) results, then only such resulting physical loss or damage is covered by this 'policy.'"

The court of appeals rejected HP Hood's argument, siding instead with Allianz. The court first explained that the exclusion's plain language applied here: "[T]he plain language of this exclusion applies to the bottle cap liner issue, whether that problem be viewed as one of faulty 'material' (the fact that the characteristics of the bottle cap liners changed as they aged), faulty 'workmanship' (the failure by [HP] Hood to apply the correct torque) or faulty 'design' (the fact that the bottling process did not take into account the changes to the liners as they aged)."[2]

The court then explained that the exclusion's exception for "resulting loss" does not "sweep back into coverage all losses caused by faulty workmanship and, in any event, such a reading would render the exclusion of no effect (something the parties are presumed not to have intended)."[3] The court observed that other courts, facing similar exclusions with exceptions, have advised that, at the very least, there must be two "separable events": one that led to the excluded damage and one that led to "resulting losses" that thereby would fall within the exception thereto; moreover, the "ensuing loss must be different in kind, not just degree." [4]

HP Hood Was Decided Correctly

The HP Hood court interpreted the "resulting loss" exception to require that some separate, covered event take place that leads to property damage separate from the excluded, faulty workmanship/design damage. Here, the court correctly held that the problem with the bottle cap liners "directly rendered the entire product unsaleable" and the "loss of that product falls squarely within the exclusion language." [5]

The main criticism of the case is that the court's interpretation of the "resulting loss" exception to the

exclusion supposedly rendered the exception “illusory.” That critique is clearly unfounded.

A policy coverage provision would be rendered “illusory” where, unlike here, the provision is interpreted such that it becomes practically impossible for an insured to obtain coverage under any set of facts. The court’s interpretation of the “resulting loss” exception here does not render it illusory; under the present facts, for example, if the bottle-cap issue had caused liquid inside the bottles to leak out, leading to the growth of mold on the shelves and floors of the facility that housed them, such losses would most likely have been considered to constitute “resulting losses.” The court here correctly construed the “resulting loss” provision to be no more than an exception to the general exclusion, thereby allowing the court to enforce the exclusion as written.

Lessons From HP Hood

Manufacturers of products, particularly food products, that elect not to purchase specialized insurance that specifically covers losses arising out of product defects, contamination and/or recalls, do so at their own peril. As the HP Hood decision shows, courts will enforce exclusions in general property insurance policies exactly as written, including exclusions for faulty workmanship/design. Policyholders are well advised to read their policies and to know exactly what is covered and what is excluded, and to ensure that they have purchased additional coverage to fill in any gaps as desired.

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[1] Id. at 770.

[2] Id. at 772-73.

[3] Id. at 774.

[4] Id. at 774 (quoting *Holden v. Connex-Metalna*, No. 98-3326, slip op. at 21, 2000 WL 1876338 (E.D. La. Dec. 22, 2000)).

[5] Id. at 774-75.