

CLIENT ADVISORY

RELIEVED OF LIABILITY – THE NEED FOR DISCONTINUED PRODUCTS COVERAGE

This article is about an organization that manufactures toilets – specifically its need to have insurance for injury or damage caused by the product it makes. As is mentioned in the prelude to many movies, this is based on a true story. Much of what follows is made up – but the coverage issues, case law and the conclusion are very real.

Acme Toilets, Inc.

Acme had been making toilets for over forty years and had developed a sterling reputation as a provider of superior products – so much so that builders from around the country had purchased and installed Acme's toilets in countless residential buildings.

The Eliminator 5000

In early 2006, Acme designed, patented and manufactured an innovative new residential toilet that used a fraction of the water needed by conventional toilets. This new product, sold as the Eliminator 5000, was extraordinarily popular and sold quickly. But as the economy slowed and the building starts dropped to virtually zero in 2007, Acme found itself with an ever increasing inventory and was forced to dramatically cut and eventually stop manufacturing, reluctantly laying off most of its workforce.

Closing its Doors

Unfortunately, the financial fortunes of Acme continued to worsen. By mid-2008, most of Acme's inventory had been sold, albeit at a reduced price. With virtually no sales, Acme decided it was time to shut its doors. The Chief Financial Officer was charged with an orderly dissolution of the corporation, which still owned substantial assets, including several manufacturing plants as well as patent rights to several products. The CFO was given 6 months from mid-2008 to complete this rather grim task.

Products Liability Insurance Costs

As part of due diligence, the CFO took a hard look at all expenses. There was one expense item in particular that jumped off the page – the cost of products liability insurance. In order to preserve what was left of the company (the remaining assets were to be distributed to its stockholders) the need to pay the costs of products liability insurance seemed dubious at best.

The CFO quickly concluded that there was no longer a need to pay for products liability insurance as products were no longer being made or sold by Acme. Further, the CFO had received word that all of the toilets made by Acme had been installed. No products remained in the stream of commerce. Without seeking the advice of his insurance broker, the CFO demanded that Acme's products liability coverage not be renewed on its anniversary date of July 1, 2008, the same day that Acme officially announced it had ceased all operations. Acme's products liability insurance was therefore terminated on July 1, 2008.

A Product Defect

Unknown to Acme or its CFO, several of the Eliminator 5000 models developed a problem – the toilets leaked. In the late summer and early fall of 2008, after Acme terminated its products liability insurance and had ceased all operations, some of the Eliminator 5000 toilets began to leak, causing substantial water damage to the homes in which the toilet was installed. The cause of the leak was found to be a defect in the product itself – not the result of improper installation. Apparently, some of the gaskets within the Eliminator 5000 corroded quickly, resulting in the leaks.

In late fall of 2008, numerous homeowners (or their insurers) brought claims against Acme, alleging substantial water damage was directly caused by the toilet leaks.

Manufacturers' Mutual Insurance Company had provided Acme "occurrence" products liability insurance for the past fifteen years – surely Manufacturers' Mutual would handle this series of unfortunate events. After all, Acme paid premium on the sale of the Eliminator 5000 models when the toilets were sold to the builders in 2006 and 2007.

Claim Denial

To the stunned surprise of Acme's CFO, Manufacturers' Mutual politely but firmly stated that no coverage existed under any Acme products liability policy for the claims resulting from the Eliminator 5000 leaks. All property damage from the leaks took place after the Manufacturers policies had been terminated.

Manufacturers' Mutual cited the following in its letter as its basis for its coverage denial:

- b. This insurance applies to "bodily injury" and "property damage" only if:
 - (1) The "bodily injury" or "property damage" is caused by an "occurrence" that takes place in the "coverage territory";
 - (2) The "bodily injury" or "property damage" occurs during the policy period;

Acme's Response

Acme litigated the coverage issue and argued that since the Eliminator 5000 was sold with a defect (unknown to Acme), that coverage should apply as the insurer's premium charge was made at the time of sale. Acme further argued that as the Eliminator

5000 was installed with a product defect (again, unknown to Acme when installed), the Manufacturers' Mutual policy at the time of installation was triggered as the installation constituted property damage.

The Court's Ruling

The court noted the following regarding the contention that the Manufacturers' Mutual policy should respond as premium was charged for the defective product when it was sold:

"...it is well settled that the time of occurrence of an 'accident' ... is not the time the wrongful act was committed but the time the complaining party was actually damaged.¹ Clearly, even under a strict products liability theory, liability does not arise until damages occur.²"

As respects the property damage taking place upon installation of the Eliminator 5000, the court noted:

"In addition, if we were to accept the policyholders' argument that, even though a product fails ...after its installation, the 'property damage' can nevertheless be backdated to the time the product was installed...would lead to the absurd result that liability insurance policies are triggered not by the actual product failure but instead by the potential product failure in the future. Insurance contracts do not provide perpetual coverage; they provide coverage only for injury that actually occurs during a finite policy period. Accordingly, coverage...is not triggered if the date ...the water damage due to a leak occurs after the policy period, even if installation...occurs within the policy period.¹"

The Underlying Claims

Though Acme was out of business when the property damage took place, Acme was found liable to pay all damages caused by the leaks from the Eliminator 5000. As Acme had no insurance, all costs had to be settled out of the assets of Acme.

Lessons Learned

After the claim denial, Acme's attorney was adamant the Acme CFO should have purchased a "tail" once the company announced it had ceased all its operations. After a little research, Acme's attorney found that a "tail" generally refers to an Extended Reporting Period, which is available only on a "claims-made" CGL policy – a "tail" could not have been obtained on the Manufacturers' "occurrence" products liability policy.

And even if Acme had a "claims-made" CGL policy for products liability, purchase of the "tail" or Extended Reporting Period (ERP) would still not have worked. An ERP for a claims-made CGL does NOT provide coverage for injuries or damage that took place after the policy expired and during the "tail" period – the CGL ERP provides coverage only if the injury or damage took place before the policy was terminated and then only if the claim for that injury or damage was made during the ERP.

Discontinued Products Liability Insurance

The CFO's conclusion that Acme's products were beyond the stream of commerce because they were all sold and installed was wrong. More importantly, this led to the mistaken belief Acme no longer was exposed to products liability claims. Acme should have continued to purchase "occurrence" products liability coverage for several years after it ceased all operations – if an ISO products liability policy had been in effect in the fall of 2008, coverage would have been afforded for the claims resulting from the leaks caused by the Eliminator 5000.

Generally known as a "discontinued products" such coverage is usually an "occurrence" products liability policy (or CGL policy) with one unique aspect – the premium is calculated differently. In the case of Acme, an insurer who undertakes to provide "discontinued products" coverage is affording coverage only for products sold before Acme ceased operations on July 1, 2008. The products exposure diminishes over time as no new products are being sold by Acme.

Consequently, it can be argued the annual premium for Acme's discontinued products liability policy should actually be the same or less than the \$50,000 per year Acme was paying with Manufacturers' Mutual Insurance Company. The practical problem is that many insurers refuse to provide coverage for discontinued products – underwriting guidelines often flatly prohibit writing any discontinued products liability coverage.

This is curious indeed, as the same insurer who would gladly offer Acme a products liability policy if the business were still viable (if Acme remained in business) would refuse to offer discontinued products coverage, noting they do not want pick up the exposure of products Acme has made over the last forty years.

Yet, any insurer writing products liability coverage for Acme would automatically pick up the exposure for all of Acme's past products – whether the products liability policy was for a manufacturer currently in business or was for a manufacturer that had ceased all operations but needed coverage only for products previously made and sold.

The solution available to Acme was a discontinued products liability policy – if not from Manufacturers' Mutual, then from a non-admitted or surplus lines insurer. As noted above, as Acme failed to purchase the discontinued products liability policy, it has suffered a significant uninsured loss.

Conclusion

Since the mid-1980s, the "trigger" of an ISO "occurrence" CGL policy has been abundantly clear – the CGL is triggered only when the bodily injury or property damage occurs during the policy period. This rather straightforward coverage issue is widely misunderstood both in and out of the risk and insurance industry. It is all too common for manufacturers to assume the CGL or

products liability policy in effect when the product is made or sold or even when it is installed will protect the organization from injury or damage that occurs months or years after the products liability policy has expired. Discontinued products liability coverage is the answer to closing this serious gap in a policyholder's insurance program.

¹ National Aviation Underwriters v. Idaho Aviation Center, 93 Idaho 668 471 P 2d 55 (Idaho 1970)

² Millers Mutual Fire Insurance Company of Texas v. Ed Bailey, Inc. Supreme Court of Idaho 647 P 2d 1249 (1982)

³ Travelers Insurance Company et al v. Eljer Manufacturing Company, Inc. Supreme Court of Illinois 757 NE 2d 481 (2001)

About the Author

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