PLUNKETT COONEY

Federal Appellate Court Rules Explicit Allegations Required to Trigger Duty to Defend Under Standard CGL Policies

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In a recent opinion, *Amerisure Mut. Ins. Co. v. Microplastics, Inc.*, 2010 WL 3619785 (CA 7 September 20, 2010), the U. S. Court of Appeals for the Seventh Circuit held, under Illinois law, that an insurer does not have a duty to defend its insured, a manufacturer, under a commercial general liability (CGL) policy, against a buyer's claim for economic losses incurred from purchasing defective products, when the complaint in the underlying litigation did not specifically allege damage to any property other than the defective products themselves. The court held that allegations of defective or faulty workmanship in the insured's own products does not, by itself, allege "property damage" under a standard CGL policy.

The underlying litigation involved Valeo Security Systems, an automotive supplier, and Microplacstics, Inc., a manufacturer of molding components. Valeo purchased molds from Microplastics for use in manufacturing automobile door latch assemblies, which Valeo in turn sold to automobile manufacturers.

Valeo received a complaint from an automotive manufacturer about problems with the door assemblies. Valeo then determined that the products supplied by Microplastics were defective, cancelled the purchase orders for cause and applied a debit of approximately $1.3 million to offset damages it suffered as a result of the defective products. Microplastics filed suit against Valeo, alleging breach of contract. Valeo counterclaimed for economic losses suffered as a result of the defective products, including unspecified costs charged back to Valeo by its customers.

Amerisure insured Microplastics under a series of CGL policies. The CGL policies required Amerisure to pay Microplastics should Microplastics ever be legally obligated to pay damages to any third party as a result of "property damage" or "personal injury" caused by an "occurrence." Amerisure sent a reservation of rights letter to Microplastics, acknowledging receipt of the Valeo counterclaim and advising Microplastics that it was "unable to provide [Microplastics] with a defense until we have completed our investigation." The letter cited the relevant coverage provisions in the Amerisure policies

and stated that "there appears to be a question as to whether or not this incident is a covered claim under the general liability policies issued to Microplastics, Inc. It does not appear that there has been any 'property damage' caused by an 'occurrence.'" Amerisure subsequently declined coverage and refused to defend Microplastics against the Valeo counterclaim.

Amerisure filed a declaratory judgment suit in the U. S. District Court for the Northern District of Illinois, seeking a ruling that it had no duty to defend or indemnify Microplastics for the Valeo counterclaim. The district court granted summary judgment to Amerisure, holding that it had no duty to defend Microplastics because the Valeo counterclaim did not allege either property damage or bodily injury as required under the CGL policies. Microplastics appealed.

On appeal, Microplastics argued that Valeo's counterclaim potentially fell within policy coverage because there was a theoretical possibility that the costs charged back to Valeo by its customers included damages to property other than the defective parts themselves. Microplastics argued that the costs may have involved damage to the personal property of purchasers of the automobiles, including trunks opening and spilling property onto roadways, or water damage to property stored inside the vehicles. Microplastics maintained that because the language of the counterclaim did not foreclose the possibility of these hypothetical instances of property damage, such allegations potentially implicated property damage under the policies and, therefore, triggered Amerisure's duty to defend.

The appellate court disagreed, finding that Microplastics' interpretation went "too far" and that while "an insurer's duty to defend in Illinois is broad, it is not without limits." The court continued, "[t]he duty to defend applies only to facts that are explicitly alleged; 'it is the actual complaint, not some hypothetical version, that must be considered.'"

Further, the court noted that "[a]n allegation of defective or faulty workmanship in the insured's own products does not, by itself, allege "property damage" under a standard CGL policy. Such policies 'are intended to protect the insured from liability for injury or damage to the persons or property of others; they are not intended to pay the costs associated with repairing or replacing the insured's defective work and products, which are purely economic losses.'"

The court noted that the counterclaim made no specific allegations regarding property damage, but, instead, simply alleged that Valeo's customer charged it for unspecified costs associated with the defective parts originally supplied by Microplastics. The court noted that if the "allegations by Valeo of unspecified costs charged back by its customer are enough to trigger the duty to defend, then we would expect that CGL insurers would quickly find themselves responsible for defending routine breach of warranty disputes between commercial manufacturers and their buyers." The court ultimately held that Valeo's counterclaim did not trigger Amerisure's duty to defend because the counterclaim "did not allege any facts that could potentially fall within the scope of covered property damage."

This decision is significant for insurers examining faulty workmanship claims under Illinois law. While the duty to defend will continue to be construed broadly, this decision supports the notion that the duty to defend is not limitless, and does not necessarily extend to hypothetical situations that could arise, but which have not been specifically alleged in the pleadings.