

ORIGINAL

THE STATE OF SOUTH CAROLINA
IN THE COURT OF APPEALS

APPEAL FROM CHARLESTON COUNTY
Court of Common Pleas

B. Hicks Harwell, Jr., Circuit Court Judge

Case No. 2002-CP-10-4390

Auto-Owners Insurance Co., Inc. Appellant,

v.

Virginia T. Newman and Trinity Construction, Inc..... Respondents.

FINAL BRIEF OF APPELLANT

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TABLE OF CONTENTS

| | |
|---|-----|
| Table of Authorities. | iii |
| Statement of Issues on Appeal. | 1 |
| Statement of the Case. | 2 |
| Statement of Facts. | 3 |
| Arguments. | 6 |
| I. THE TRIAL COURT ERRED IN HOLDING THE DAMAGES WERE COVERED BECAUSE THERE WAS NOT AN ACCIDENT. | 6 |
| II. THE TRIAL COURT ERRED IN FINDING THE POLICY COVERED THE ALLOWANCE FOR THE SUBSTRATE BECAUSE THE POLICY EXCLUDES PROPERTY DAMAGE THAT TRINITY CAN EXPECT TO OCCUR. | 14 |
| III. THE TRIAL COURT ERRED IN FINDING THE STUCCO REMOVAL AND REPLACEMENT WAS COVERED BECAUSE FAULTY WORKMANSHIP IS NOT AN "OCCURRENCE". | 17 |
| Conclusion | 18 |
| Certificate of Service | 19 |

TABLE OF AUTHORITIES

CASES

| | |
|--|----------|
| <u>Auto-Owners Ins. Co. v. Haman</u> , 368 S.C. 536, 629 S.E.2d 683 (Ct. App. 2006) | 6 |
| <u>Campbell v. Marion County Hosp. Dist.</u> , 354 S.C. 274, 580 S.E.2d 163 (Ct. App.2003) | 6 |
| <u>C.D. Walters Const. Co., Inc. v. Fireman’s Ins. Co. of Newark</u> , 281 S.C. 593, 316 S.E.2d 709 (Ct. App. 1984) | 8-9, 17 |
| <u>Century Indem. Co. v. Golden Hills Builders, Inc.</u> , 348 S.C. 559, 561 S.E.2d 355 (2002) | 6, 9 |
| <u>Gamble v. Travelers Ins. Co.</u> , 251 S.C. 98, 160 S.E.2d 523 (1968) | 7 |
| <u>Green v. United Ins. Co. of America</u> , 254 S.C. 202, 174 S.E.2d 400 (1970) | 8 |
| <u>Hansen ex rel. Hansen v. United Services Auto. Ass’n</u> , 350 S.C. 62, 565 S.E.2d 114 (Ct. App. 2002) | 6 |
| <u>High Country Associates v. New Hampshire</u> , 648 A.2d 474 (N.H. 1994) | 15 |
| <u>Isle of Palms Pest Control Co. v. Monticelo Ins. Co.</u> , 319 S.C. 12, 459 S.E.2d 318 (Ct. App.1994) | 9 |
| <u>Kennedy v. Columbia Lumber and Mfg. Co., Inc.</u> , 299 S.C. 335, 284 S.E.2d 730, 736 (1989) | 12 |
| <u>L-J, Inc. v. Bituminous Fire and Marine Ins. Co.</u> , 366 S.C. 117, 621 S.E.2d 33 (2005) | 9-10, 15 |
| <u>Nationwide Mut. Ins. Co. v. Tate</u> , 313 S.C. 444, 438 S.E.2d 266 (1993) | 3 |
| <u>Palmetto Homes, Inc. v. Bradley</u> , 357 S.C. 485, 593 S.E.2d 480 (Ct. App. 2005) | 18 |
| <u>Penn America Ins. Co. v. Valade</u> , 28 Fed.Appx. 253 (4th Cir. N.C. 2002) | 7 |
| <u>Rakestraw v. Allstate Ins. Co.</u> , 238 S.C. 217, 119 S.E.2d 746 (1961) | 7 |
| <u>Richburg v. Baughman</u> , 290 S.C. 431, 351 S.E.2d 164 (1986) | 18 |

S.S. Newell & Co. v. American Mutual Liability Ins. Co., 199 S.C. 325, 19 S.E.2d 463 (1942)7

Sunex Intern., Inc. v. Travelers Indem. Co., 185 F.Supp. 2d 614 (D.S.C. 2001) 6-7

Torrington Co. v. Aetna Cas. & Sur. Co., 264 S.C. 636, 216 S.E.2d 547 (1975). .3

USAA Property and Cas. Ins. Co. v. Rowland, 312 S.C. 536, 435 S.E.2d 879 (Ct. App. 1993) 8

STATEMENT OF ISSUES ON APPEAL

- I. DID THE TRIAL COURT ERR IN HOLDING THE DAMAGES WERE COVERED EVEN THOUGH THERE WAS NOT AN ACCIDENT?
- II. DID THE TRIAL COURT ERR IN FINDING THE POLICY COVERED THE ALLOWANCE FOR THE SUBSTRATE EVEN THOUGH THE POLICY EXCLUDES PROPERTY DAMAGE THAT TRINITY CAN EXPECT TO OCCUR?
- III. DID THE TRIAL COURT ERR IN FINDING THE STUCCO REMOVAL AND REPLACEMENT WAS COVERED EVEN THOUGH FAULTY WORKMANSHIP IS NOT AN "OCCURRENCE"?

STATEMENT OF THE CASE

On March 3, 2000, Virginia T. Newman ("Newman") filed a civil action in the Court of Common Pleas for Charleston County against Trinity Construction, Inc. ("Trinity"), alleging defective construction of her home. Upon referral to binding arbitration by both parties, M. Dawes Cook, Jr., Esq. arbitrated the dispute and issued a written award by letter dated August 9, 2002. Following this award, Auto-Owners, Trinity's insurer, sought a declaratory judgment to the effect that the damages determined by the arbitrator were not covered losses under the contract. In an order dated December 14, 2005, The Honorable B. Hicks Harwell, Jr. found all damages came within the policy's coverage. This appeal followed.

STATEMENT OF FACTS

Defendant Trinity Construction, Inc. ("Trinity") and Defendant Virginia T. Newman ("Newman") entered into a contract for Trinity to construct a house for Newman in Mt. Pleasant, South Carolina. A certificate of occupancy was issued on May 28, 1999. Disputes between Newman and Trinity arose during and after the construction of the house. Newman thereafter hired Robert G. Sisroy, P.E. ("Sisroy") to inspect the construction of the house. Sisroy wrote a report for Newman dated September 2, 1999 entitled "Construction Deficiencies Investigation". (R. p. 61, lines 18-23; p. 93, line 16-25). Based on the report, Newman filed a civil action against Trinity, alleging defective construction of the house, mostly relating to the stucco siding.

Newman alleged in her complaint causes of action against Trinity for breach of contract, negligence and breach of warranty. Pursuant to a Commercial General Liability policy issued to Trinity, Auto-Owners sent a reservation of rights letter regarding coverage and provided counsel to defend Trinity.¹ Newman and Trinity referred the action to binding arbitration. The arbitrator awarded certain damages to Newman based on an itemized estimate that a Newman expert prepared for the arbitration. (R. p. 59, lines 6-21). The

¹ A liability insurer has two (2) separate and distinct duties to its insured: 1) the insurer is obligated to pay certain sums the insured becomes legally obligated to pay; and 2) the insurer must defend any suit alleging bodily injury or property damage seeking damages payable under terms of insurable policy. Nationwide Mut. Ins. Co. v. Tate, 313 S.C. 444, 447, 438 S.E.2d 266, 268 (1993). An insurer has an obligation to indemnify an insured only for those damages covered under the terms of the policy. Moreover, an insurer has no duty to indemnify an insured for damages unambiguously excluded under the policy. Torrington Co. v. Aetna Cas. & Sur. Co., 264 S.C. 636, 643, 216 S.E.2d 547, 550 (1975).

arbitrator explained in some detail in his letter the basis for his award or damages. (R. p. 59, lines 18-25).

Auto-Owners issued a Tailored Protection Insurance Policy with Commercial General Liability coverage to Trinity effective for the period July 7, 1993 to July 27, 2000. (the "Policy"). (R. p. 64, line 22 – p. 65, line 7). Auto-Owners commenced the civil action seeking declaratory relief to determine its rights and obligations under the Policy. Auto-Owners contended that the damages awarded by the arbitrator were not covered by the Policy. The Honorable B. Hicks Harwell, Jr. held a non-jury trial on October 31, 2005. The trial court disagreed with Auto-Owners' position, finding the damages came within the Policy's coverage. (R. p. 6).

The damages awarded by the arbitrator can be divided into three categories:²

- a) The costs of the replacement of the stucco exterior siding;
- a) The costs for miscellaneous repairs that will be incidental to the stucco's removal; and
- c) An allowance of \$1,000.00 for any damaged exterior sheathing and framing (the "substrate") that may exist.³

With respect to the stucco replacement and the miscellaneous costs incidental to the removal of the stucco, the trial court found that the damages were covered because "[t]here is no other way to address the underlying damage

² There are miscellaneous damages that the trial court found were not covered by the Policy.

³ The Arbitrator awarded the amount of \$970.00 for a screen porch condition that apparently buckled. Newman contends these amounts are an occurrence of property damage. The

caused to the substructure and the sheathing than to strip and replace the exterior stucco in its entirety." (R. p. 6). With respect to the allowance for the substrate, the trial court found that the sum was within the policy's coverage. (R. p. 4).

arguments made herein by Auto-Owners relative to faulty workmanship apply the same to this condition. Accordingly, the amount is not covered by the Policy.

STANDARD OF REVIEW

Declaratory judgment actions are neither legal nor equitable, and therefore, the standard of review depends on the nature of the underlying issues. Campbell v. Marion County Hosp. Dist., 354 S.C. 274, 279, 580 S.E.2d 163, 165 (Ct. App.2003). When the purpose of the underlying dispute is to determine whether coverage exists under an insurance policy, the action is one at law. Auto-Owners Ins. Co. v. Haman, 368 S.C. 536, 536, 629 S.E.2d 683, 685 (Ct. App. 2006) (internal citation omitted). In an action at law tried without a jury, the appellate court will disturb the trial court's findings of fact if there is no evidence that reasonably supports those findings. Id.

ARGUMENT

I. THE TRIAL COURT ERRED IN HOLDING THE DAMAGES WERE COVERED BECAUSE THERE WAS NOT AN ACCIDENT.

"The construction and enforcement of an unambiguous contract is a question of law for the court." Hansen ex rel. Hansen v. United Services Auto. Ass'n, 350 S.C. 62, 67, 565 S.E.2d 114, 116 (Ct. App. 2002). Insurance policies are subject to the general rules of contract construction. Century Indem. Co. v. Golden Hills Builders, Inc., 348 S.C. 559, 565, 561 S.E.2d 355, 358 (2002) (internal citations omitted). The Court must give policy language its plain, ordinary, and popular meaning. Id. When a contract is unambiguous, clear, and explicit, it must be construed according to the terms the parties have used. Id. "An insurer's obligation under a policy of insurance is defined by the terms of the policy and cannot be enlarged by judicial construction." Sunex Intern., Inc. v. Travelers Indem. Co., 185 F.Supp. 2d 614, 617 (D.S.C. 2001). The rule of strict

construction against the insurer does not apply when the language used in the policy is so plain and unambiguous as to leave no room for construction. S.S. Newell & Co. v. American Mutual Liability Ins. Co., 199 S.C. 325, 19 S.E.2d 463, 466 (1942).

Trinity and Newman had the initial burden of proof in this matter. In a declaratory judgment action, “[t]he burden of proof is on the insured to show that a claim falls within the coverage of an insurance contract. The insurer bears the burden of establishing exclusions to coverage.” Sunex Intern, Inc., 185 F.Supp.2d at 617 (internal citations omitted); Gamble v. Travelers Ins. Co., 251 S.C. 98, 160 S.E.2d 523 (1968). The same is true for any person seeking coverage under an insurance policy. See Rakestraw v. Allstate Ins. Co., 238 S.C. 217, 119 S.E.2d 746, 749 (1961) (“The burden of proving coverage under the omnibus clause of an insurance policy is upon the person seeking coverage.”). The fact that Auto-Owners initiated the declaratory judgment action does not alter the burden of proof. See Penn America Ins. Co. v. Valade, 28 Fed.Appx. 253, 259 (4th Cir. N.C. 2002) (stating a party seeking coverage under an insurance policy bears the burden of proving that any claimed damage falls within the policy’s terms and this burden of proof remains unchanged when the insurer initiates a declaratory judgment proceeding concerning its coverage obligations under an insurance policy).

The Policy states Auto-Owners Insurance "will pay those sums that the insured becomes legally obligated to pay as damages because of... 'property damage' to which this insurance applies." See 1(a). The policy states that “this

insurance applies to...'property damage' only if: (1)...the 'property damage' is caused by an 'occurrence' ...;and (2)...'property damage' occurs during the policy period." See 1(b). The Policy then has a number of exclusions that may be applicable to a construction defect claim. ⁴

The term "property damage" is defined by the Policy as "physical injury to tangible property, including all resulting loss of use of that property." See 12(a). The Policy defines the word "occurrence" as "an accident, including continuous or repeated exposure to substantially the same general harmful condition." See 9.

The trial court erred in holding the damages are covered because there was not an accident. An accident must cause the property damage. See Policy 1(a). The word "occurrence" is defined in the Policy, to mean an accident, but the word "accident" is not defined in the Policy. In the absence of a definition, the term "should be defined according to the ordinary and usual understanding of the term's significance to the ordinary person." USAA Property and Cas. Ins. Co. v. Rowland, 312 S.C. 536, 539, 435 S.E.2d 879, 881-82 (Ct. App. 1993) (specifically discussing the word "accident"). In this case, this Court defined the word "accident" to be "an unexpected happening or event, which occurs by chance and usually suddenly, with harmful result, not intended or designed by the one suffering the harm or hurt." 312 S.C. at 540, 435 S.E.2d at 882 (quoting Green v. United Ins. Co. of America, 254 S.C. 202, 174 S.E.2d 400 (1970)).

For there to be coverage, faulty construction must cause an accident. C.D. Walters Const. Co., Inc. v. Fireman's Ins. Co. of Newark, 281 S.C. 593, 596,

⁴ See Exclusion J, K, L and M of the Policy.

316 S.E.2d 709, 711 (Ct. App. 1984); Isle of Palms Pest-Control Co. v. Monticelo Ins. Co., 319 S.C. 12, 459 S.E.2d 318 (Ct. App.1994). In C.D. Walters, this Court held the following proposition:

The consequence of not performing well is part of every business venture; the replacement or repair of faulty goods and works is a business expense, to be borne by the insured-contractor in order to satisfy customers [. . .]. [A] comprehensive general liability policy does not cover . . . faulty workmanship, but rather faulty workmanship which causes an accident.

281 S.C. at 596-97, 316 S.E.2d at 711-12 (emphasis added).

The faulty construction discussed herein did not cause an accident. First, the damages found to be covered were sustained by the insured's work product. The South Carolina Supreme Court has stated, "[b]ased on the law of this State, coverage for the repair and/or replacement of the substrate and substructure of the home is excluded by the faulty workmanship provision." Century Indem. Co., 348 S.C. at 566, 561 S.E.2d at 359 (addressing a stucco clad house and citing Engineered Prod., Inc. v. Aetna Cas. & Sur. Co., 295 S.C. 375, 368 S.E.2d 674 (Ct. App. 1988)). Furthermore, this Court found in C.D.Walters that a comprehensive general liability policy excluded property damage to work performed by the insured arising out of the work and did not involve accidental injury to property other than that on which the insured performed its work. 281 S.C. at 598, 316 S.E.2d at 712.

Under the most recent decision of the South Carolina Supreme Court concerning a CGL policy and defective construction, L-J, Inc. v. Bituminous Fire and Marine Ins. Co., 366 S.C. 117, 621 S.E.2d 33 (2005), the Supreme Court

held that damage caused by faulty workmanship and sustained only by the insured's own work product is not a covered loss. Id. at 123, n.4, 621 S.E.2d at 36, n. 4.

The Supreme Court also made the following statement:

Although our courts have not addressed the specific issue of whether faulty workmanship constitutes an occurrence, we have addressed the issue of whether CGL policies are intended to cover faulty workmanship. For example, this Court has held that a CGL policy is not intended to cover economic loss resulting from faulty workmanship. Century Indem. Co. v. Golden Hills Builders, Inc., 348 S.C. 559, 563-64, 561 S.E.2d 355, 357 (2002). Moreover, our court of appeals has held that any liability that is incurred because of faulty workmanship is part of the insured's contractual liability, not an insurable event under a CGL policy. Isle of Palms Pest Control Co. v. Monticello Ins. Co., 319 S.C. 12, 16, 459 S.E.2d 318, 320 (Ct. App. 1995); see also C.D. Walters Constr. Co., Inc. v. Fireman's Ins. Co. of Newark, 281 S.C. 593, 596-97, 316 S.E.2d 709, 711 (Ct. App. 1984) (holding that faulty workmanship is a business risk that is not intended to be covered by a CGL policy).

Id. at 121-22, 621 S.E.2d at 35.

The Supreme Court stated, “[t]he CGL policy may, however, provide coverage in cases where faulty workmanship causes a third party bodily injury or damage to other property, not in cases where faulty workmanship damages the work product alone.” Id. at 123, n.4, 621 S.E.2d at 36, n. 4. The Supreme Court added “that the damage in the present case did not constitute an 'occurrence'. If we were to hold otherwise, the CGL policy would be more like a performance bond, which guarantees the work, rather than like an insurance policy, which is intended to insure against accidents.” Id. at 123, 621 S.E.2d at 36.

In the present matter, the only damages alleged were sustained entirely by Trinity's work product, i.e. the house. There are no allegations of “third party

bodily injury or damage to other property,” that are required for there to be an “occurrence”. In the same vein, there is no doubting—and Newman tacitly conceded by seeking to recover from Trinity for the damages to all the different parts of the house—that the entire house is Trinity’s work product alone. The house in its entirety, including the substrate, are Trinity’s work product. Because the allowance for the substrate is or relates to Trinity’s work product, the trial court erred in finding a covered loss.

Second, neither Newman nor Trinity offered evidence of an accident—the “unexpected happening or event”—that is a prerequisite to coverage under the Policy. Newman and Trinity offered no evidence of an accident because there was no accident. All the damages that the trial court found to be covered are the natural and foreseeable consequences of Trinity’s faulty workmanship. Items, such as replacing the gutter system, removing and replacing the windows, and performing demolition of the stucco, are necessary, according to Sisroy, only because the defectively installed stucco must be removed. (R. p. 114-126). These items of repair are specifically related to the faulty workmanship or merely incidental to the replacement of the stucco.

Sisroy stated unequivocally that any damage to the substrate is the foreseeable consequence of Trinity’s faulty workmanship. Questioned about Trinity’s faulty construction, Sisroy agreed that “the obvious consequence of not doing this...is wood rot underneath” the stucco system. (R. p. 144, lines 1-6) (emphasis added). Sisroy later put it even more plainly: “I would expect water intrusion rot and rot if the system is installed improperly.” (R. p. 158, lines 12-21).

Damage to the substrate is the obvious consequence of Trinity's defective construction, and Sisroy's expectation that damage would result did not depend on the occurrence of some accident.

Since the defective construction cannot be an accident by law, and an accident must cause property damage, one must then determine just what accident occurred herein. Newman's position is basically that rainwater damaged the substrate of her home, which means the rain must be the accident. In sum, Newman's position is Trinity improperly constructed the house thereby allowing the rain to damage the substrate. Plainly, there is nothing unexpected or accidental about the fact that it will rain.

Trinity is charged by law to construct a building in accordance with the applicable building code and industry standards. Kennedy v. Columbia Lumber and Mfg. Co., Inc., 299 S.C. 335, 284 S.E.2d 730, 736 (1989). It is the building code that Trinity must follow by law to construct the house to be weather resistant. Sisroy's report, which was admitted into evidence at trial, relies on the applicable building code (1995 CABO One and Two Family Dwelling Code) for the construction of this house. Trinity failed to follow the Code to construct the house and to protect it from the weather. (R. p. 134, lines 4-12; p. 143, lines 5-19; p. 287-288).

Sisroy set forth in his report how Trinity failed to install various material components that are common and integral to making a house weather resistant. The pertinent Code provision states: "Approved corrosion-resistive flashing shall be provided at the top and sides of all exterior window and door openings in such

a manner as to be leakproof." (1995 CABO One and Two Family Dwelling Code, Section 703.8) (R. p. 288) (emphasis added). Obviously, the natural and foreseeable consequence of failing to satisfy this requirement is that the system will not be leakproof, and that the rain will reach the substrate.

Another pertinent section, with which Trinity failed to comply when it constructed the house without the required stucco thickness, states, "All exterior walls shall be covered with approved materials designed and installed to provide a barrier against the weather." (1995 CABO One and Two Family Dwelling Code, Section 703.1) (R. p. 288) (emphasis added). Once more, it is manifest that Trinity's failure to satisfy this stricture will lead, without the assistance of any accident or fortuitous event, to rain reaching the substrate.

The final authority with which Trinity failed to comply, thereby becoming liable under the arbitrator's award, is the industry standard that requires a weep system. (R. p. 98, lines 8-9; p. 288). The weep system exists so the stucco will "be able to [expel] water that enters the system." (R. p. 97, lines 18-19). Because of Trinity's faulty workmanship in omitting a weep system, "there was no place for water that may enter the system to be able to weep." (R. p. 98, lines 2-4). The obvious, direct, and expected consequence of not installing a weep component on a stucco system is water will reach and damage the substrate.

Taking together all of Newman's evidence presented at trial, the only tenable conclusion is the Policy does not cover the substrate contemplated by the allowance in the arbitrator's award. Newman's own expert stated any damage to the substrate is the "obvious consequence" of Trinity's defective

construction. (R. p. 127, lines 5-10; p. 144, lines 1-8). And Sisroy's testimony jibes logically with the authorities on which he relied in opining that Trinity was liable for the stucco removal. The building code and applicable industry standard required the stucco be appropriately thick; the system be installed with a weep component; and the stucco be installed with the necessary flashing. Each of these requirements exists specifically to prevent precisely the type of damage that was expected here, which is rainwater reaching the substrate.

In sum, because the replacement of the substrate is Trinity's work product alone there is not an occurrence of property damage. Because the replacement of the substrate is incidental to and the natural and foreseeable consequence of Trinity's faulty workmanship, it was not caused by an "accident", and therefore was not an "occurrence" under the Policy. The trial court erred in holding otherwise and should be reversed.

II. THE TRIAL COURT ERRED IN FINDING THE POLICY COVERED THE ALLOWANCE FOR THE SUBSTRATE BECAUSE THE POLICY EXCLUDES PROPERTY DAMAGE THAT TRINITY CAN EXPECT TO OCCUR.

Exclusion 2a of the contract excludes from coverage the damages awarded by the arbitrator. Exclusion 2a of the policy states that "[t]his insurance does not apply to: a) property damage expected...from the standpoint of the insured." (R. p. 237) The evidence offered at trial indicates that Trinity, or a reasonable builder, expects water to reach the substrate because of defective construction. Again, that is precisely why the building code requires Trinity be construct a house in a certain manner in the first place.

The resolution of this issue is not controlled by L-J, Inc., 366 S.C. 117, 621 S.E.2d 33. In that case, the South Carolina Supreme Court did not address the exclusion, at least in part because the New Hampshire case the Court relied upon, High Country Associates v. New Hampshire, 648 A.2d 474 (N.H. 1994), did not reach the exclusion. L-J, Inc., 366 S.C. at 123, 621 S.E.2d at 36. The court in High Country Associates reversed the grant of summary judgment. 648 A.2d at 478.

Sisroy testified that a construction or design professional would expect moisture damage to be the natural consequence of Trinity's negligent acts and omissions. Further, the evidence at trial showed that Trinity's defective construction alone were of such magnitude that Trinity would have been required by law to anticipate them. Taken together, and by law, it was clear that Trinity knew or must know and expect as a licensed builder, of the consequences of defective construction—that rainwater will reach the substrate if Trinity did not construct the house in accordance with the building code. Because the loss is unambiguously excluded from coverage under the Policy, the trial court erred to find the exclusion did not apply herein.

With respect to whether the water damage was "expected," Sisroy, testified unequivocally that water damage is the logical and foreseeable—i.e., expectable—consequence of Trinity's negligent construction practices: too-thin application of the stucco, omission of a Building Code-required weep system, and omission of Code-required flashings, all of which were established conclusively by the arbitrator. Regarding Trinity's failure to comply with the

applicable building code, Sisroy agreed that “the obvious consequence of not doing this... is wood rot underneath” the stucco system. (R. p. 144, lines 1-6) (emphasis added). Later in his testimony, Sisroy reiterated this principle. When asked “If the system is installed wrong, you as an engineer or the reasonable builder, expects there to be water intrusion and rot over a period of time?,” Sisroy responded, “I would expect water intrusion and rot if the system is installed improperly, yes.” (R. p. 158, lines 12-21). Given that the arbitrator found that the stucco was in fact installed improperly (R. p. 11), Sisroy’s testimony established that an engineer or builder expects rainwater to get to the substrate.

The omissions in the construction committed by Trinity are in no way subtle or obscure. Sisroy testified in strong terms that the weep and flashing components are fundamental to the construction. After testifying that Trinity failed to install a weep system, Sisroy stated that “[t]he primary premise and the protocol for plaster stucco is that it be able to weep water.” (R. p. 97, lines 16-19.) (emphasis added). Similarly, with respect to the Trinity’s failure to install Code-required flashings, Sisroy testified that, “[t]he premise, basic premise, for stucco is also that there be flashings at the head of the windows, doors, and so on.” (R. p. 98, lines 14-17) (emphasis added). In short, the testimony at trial was clear: the weep and flashing components are as much a part of the stucco as are sand and mortar. As a result, Trinity must by law build to expect and prevent the consequences.⁵

⁵ Interestingly, at trial, Newman’s attorney objected, unsuccessfully, that the court should not permit Sisroy to testify as to whether Trinity would have expected the water damage to occur. (R. p. 159, lines 9-17). However, the court over-ruled the objection, allowing Sisroy to continue,

Given the trial court's pronouncement that Trinity could be charged with expecting the water damage; and that the evidence showed that Trinity would indeed have expected it; then the trial court's conclusion that Exclusion 2a does not apply is clearly erroneous.

III. THE TRIAL COURT ERRED IN FINDING THE STUCCO REMOVAL AND REPLACEMENT WAS COVERED BECAUSE FAULTY WORKMANSHIP IS NOT AN "OCCURRENCE".

Even if the substrate is a covered loss, the removal and replacement of the stucco is not. Faulty workmanship is not an "occurrence" and therefore is not a covered loss. See, e.g. C.D. Walters Constr. Co., Inc., 281 S.C. at 596-97, 316 S.E.2d at 711 (Ct. App. 1984) (holding that faulty workmanship is a business risk that is not intended to be covered by a CGL policy).

In his award, the arbitrator, found that, "[t]he system may be functional now, but I have to assume that there is good reason why the Code requires additional thickness. I also feel that there are sufficient other problems with the installation—lack of weep holes, flashing, etc.—that allowance needs to be made for replacement of the system." (R. p. 11). The import of this language is clear. The stucco needed to be replaced because it was installed improperly, which is plainly faulty workmanship. The arbitrator did not so much as mention that the stucco needed to be removed so that the substrate could be replaced as damaged; yet this latter proposition is precisely what the trial court held. (R. p. 6).

and holding that the insured "may be charged with the responsibility of knowing what he knew." (R. p. 159, line 24 – p. 160, line 2).

The trial court's holding, which is the sole means by which the stucco removal was found to be a covered loss, is in direct contravention to the arbitrator's findings: that the stucco needs to be replaced because of the faulty workmanship by Trinity. This holding then violates the principle of collateral estoppel. Under the doctrine of collateral estoppel, once final judgment on the merits has been reached in a prior claim, relitigation of those issues actually and necessarily litigated and determined in the first suit are precluded in any subsequent action based upon a different claim.⁶ Richburg v. Baughman, 290 S.C. 431, 434, 351 S.E.2d 164, 166 (1986). The award of the arbitrator is a final judgment. See Palmetto Homes, Inc. v. Bradley, 357 S.C. 485, 593 S.E.2d 480 (Ct. App. 2005).

It was not within the trial court's discretion to displace the arbitrator's finding. It is patent that the removal of the stucco is a loss that falls outside the Policy's coverage.

CONCLUSION

The Court should reverse the lower court.

RESPECTFULLY SUBMITTED



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⁶ Trinity basically agrees that the arbitration award invokes collateral estoppel. (R. p. 149, lines 6-25).

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CERTIFICATE OF SERVICE

I, Susan Bennett, an employee of the law firm of Ellis, Lawhorne & Sims, P.A., do hereby certify that I served ~~one~~ ^{three copies} of Appellant Auto-Owners Insurance Co., Inc.'s Final Brief this the 16th day of November 2006 upon all counsel of record by depositing same in the U.S. Mail, postage prepaid and addressed as follows:

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THE STATE OF SOUTH CAROLINA
IN THE COURT OF APPEALS

APPEAL FROM CHARLESTON COUNTY
Court of Common Pleas

B. Hicks Harwell, Jr., Circuit Court Judge

Case No. 2002-CP-10-4390

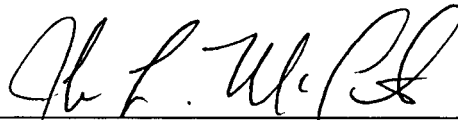
Auto-Owners Insurance Co., Inc. Appellant,

v.

Virginia T. Newman and Trinity Construction, Inc. Respondents.

CERTIFICATE OF COUNSEL

The undersigned certifies that this Final Brief complies with Rule 211(b),
SCACR.



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April 17, 2009

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APR 17 2009

S.C. SUPREME COURT

The Honorable Daniel E. Shearouse
Clerk of Court
South Carolina Supreme Court
Post Office Box 11330
Columbia, SC 29211

RE: Auto-Owners Insurance Co., Inc. v. Virginia T. Newman and
Trinity Construction, Inc.
Civil Action No. 2002-CP-10-4390
Our File No. 01226/01602

Dear Mr. Shearouse:

Pursuant to SCACR 208(b)(7), Appellant Auto-Owners Insurance Co., Inc. hereby notifies the Clerk of Court of a pertinent and significant authority that has come to Appellant's attention after briefing was completed in the above-referenced case:

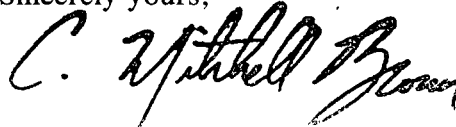
Nationwide Ins. Co. v. CPB International, Inc., et. al., Case No. 07-4772 (3d Cir. Filed April 14, 2009) (faulty workmanship not an occurrence because it is not an accident and element of fortuity is lacking; "natural and foreseeable acts . . . which tend to exacerbate the damage, effect, or consequences caused by *ab initio* by faulty workmanship also cannot constitute an 'occurrence' or 'accident' for the purposes of an occurrence based CGL policy").

Therefore, Appellant respectfully requests that the aforementioned case supplement Appellant's Brief at pp. 6-18 and Appellant's Reply Brief at pp. 5-6 as it is relevant to the issue of whether there was an occurrence as defined by the CGL insurance policy in this matter.

The Honorable Daniel E. Shearouse
April 17, 2009
Page 2

By copy of this letter, we are serving opposing counsel with a copy of this supplemental citation.

Sincerely yours,

A handwritten signature in cursive script that reads "C. Mitchell Brown". The signature is written in dark ink and is positioned above the printed name.

C. Mitchell Brown

CMB:amb

Enclosure

cc: Joseph K. Qualey, Esquire
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PRECEDENTIAL

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 07-4772

NATIONWIDE MUTUAL INSURANCE COMPANY

v.

CPB INTERNATIONAL, INC.:
NBTY, INC.: REXALL SUNDOWN, INC.

CPB International, Inc.,
Appellant

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF PENNSYLVANIA
(D.C. Civil No. 06-cv-00363)
District Judge: Honorable A. Richard Caputo

Submitted Under Third Circuit LAR 34.1(a)
March 3, 2009

Before: BARRY, WEIS, and ROTH, Circuit Judges

(Opinion Filed: April 14, 2009)

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APR 17 2009

S.C. SUPREME COURT

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OPINION OF THE COURT

BARRY, Circuit Judge

CPB International ("CPB") appeals the District Court's grant of Nationwide Mutual Insurance Company's ("Nationwide") motion for summary judgment in this declaratory judgment action that Nationwide filed to determine its obligations under a commercial general liability ("CGL") policy it had issued to CPB (the "policy"). The central issue is whether the policy required Nationwide to defend and indemnify CPB against an action brought by Rexall Sundown, Inc. and a related corporation, NBTY, Inc. (collectively "Rexall"). The action alleged that CPB breached a contract for the delivery of goods by providing a defective product and sought consequential damages for that breach. The District Court held that because the underlying claim was "contractual in nature," it was not covered by the terms of the policy. We will affirm, predicting, as we do so, that the Supreme Court of Pennsylvania would hold that an action arising out of a contract between the parties is not covered by a CGL policy in Pennsylvania.

I.

CPB is an importer and wholesaler of chondroitin, a nutritional supplement made from animal cartilage. CPB imports chondroitin manufactured in China and sells it to companies in the United States which combine chondroitin and glucosamine, a nutritional supplement made from crab, lobster and shrimp shells, with other ingredients to manufacture nutritional tablets. The tablets are beneficial to people who suffer from osteoarthritis. Nationwide issued a CGL policy to CPB, which the parties agree was in effect at the time of the alleged breach. Under the policy, Nationwide agreed to "pay those sums that [CPB] be[came] legally obligated to pay as damages because of . . . 'property damage' to which this insurance applies." (Appendix at 134.)

Although the present action is between Nationwide and CPB, the underlying dispute is between Rexall and CPB. Our focus is whether that dispute triggers Nationwide's duties under the policy.

A. The Underlying State Court Litigation.

CPB has been a Rexall vendor since at least 1997, and agreed, as recently as June 11, 2003, to Rexall's vendor compliance regulations. Pursuant to that agreement, CPB promised to deliver products of the highest industry standards, and Rexall was entitled to reject imperfect goods and all goods not conforming to purchase order requirements.

On October 1, 2004, Rexall ordered 10,000 kilograms of chondroitin at seventy-six dollars per kilogram from CPB. On October 27, 2004, Rexall ordered an additional 10,000 kilograms of chondroitin at the same price. In December 2004, CPB filled the first order, and billed Rexall \$760,000 by invoice. Rexall paid the invoice in January 2005. Thereafter, CPB partially filled Rexall's second order by sending it 9,500 kilograms of chondroitin, and billing it \$722,000. Rexall did not pay for the second shipment.

In April 2005, CPB filed suit against Rexall for breach of contract and demanded payment for the second shipment. Rexall filed an answer and counterclaim (the "underlying claim"), alleging that the chondroitin that was shipped to it was deficient, of improper composition, and unusable for its intended purpose, and

that the delivery of the material constituted a material breach of contract. Rexall thus sought return of its initial \$760,000 payment and consequential damages in an amount exceeding \$1,195,465 for the shipment of the allegedly defective chondroitin. Rexall did not discover that the chondroitin was of improper composition until after it had already combined it with glucosamine and other ingredients to form the nutritional tablets. The tablets, which were mixed with ingredients valued at more than \$991,015, are now allegedly useless and without value.

CPB tendered the underlying claim to Nationwide pursuant to the policy. Nationwide assumed defense of the action, but did so under a reservation of rights.

B. The Policy.

Nationwide is bound to pay damages that CPB “becomes legally obligated to pay . . . because of . . . ‘property damage’ to which [the policy] applies.” The policy applies “only if . . . ‘property damage’ is caused by an ‘occurrence’ that takes place in the ‘coverage territory.’” (Appendix at 134.) Both “property damage” and “occurrence” are defined terms. Property damage means “[p]hysical injury to tangible property, including all resulting loss of use of that property . . . or [l]oss of use of tangible property that is not physically injured.” (*Id.* at 147.) “Occurrence” is defined as “an accident, including continuous or repeated exposure to substantially the same general harmful conditions.” (*Id.* at 146.)

The policy also features express exclusions, including one that is particularly relevant here. Exclusion “b” is entitled “Contractual Liability,” and states that the “insurance does not apply to . . . ‘property damage’ for which the insured is obligated pay damages by reason of the assumption of liability in a contract or agreement.” (Appendix at 135.)¹

¹ The contractual liability exclusion also has two carve outs:

This exclusion does not apply to liability for damages:

- (1) That the insured would have in the absence of the

C. The Present Action.

On February 16, 2006, Nationwide filed this action seeking a declaratory judgment that it owed no duty to defend or indemnify CPB against Rexall's claims. Nationwide asserted that the underlying claim did not allege an "occurrence" covered under the policy, and, alternatively, that the contractual liability exclusion barred coverage. CPB, in turn, filed a counterclaim on May 8, 2006, seeking a judgment declaring precisely the opposite – that Nationwide does owe CPB a duty to defend and indemnify it against the claims asserted by Rexall.

The parties filed cross-motions for summary judgment, and the District Court granted Nationwide's motion. It held that "[b]oth the allegation that CPB did not provide the material it was obligated to under the contract [with Rexall], and the allegation that such breach caused consequential damage to [Rexall's] property are claims based on duties CPB owed [Rexall] only by virtue of having entered into a contract with [it]. As such, the underlying claims are based in contract, and do not arise from covered 'occurrences.'" (Appendix at 18-19.) Alternatively, the Court held that the contractual liability exclusion applied to Rexall's claims.

II.

"Our standard of review of a grant of summary judgment is plenary." *Gardner v. State Farm Fire & Cas. Co.*, 544 F.3d 553,

contract or agreement: or

(2) Assumed in a contract or agreement that is an 'insured contract,' provided the . . . 'property damage' occurs subsequent to the execution of the contract or agreement.

(Appendix at 135.) "Insured contract" is a defined term, and is not relevant here. (*See id.* at 145 (term includes a lease, sidetrack agreement, easement, license agreement, obligation to indemnify a municipality, and elevator maintenance agreement).)

557 (3d Cir. 2008).²

“Under Pennsylvania law, which the parties agree is applicable here, the interpretation of an insurance contract regarding the existence or non-existence of coverage is generally performed by the court.” *Id.* at 558 (quoting *Donegal Mut. Ins. Co. v. Baumhammers*, 938 A.2d 286, 290 (Pa. 2007)); see *Kvaerner Metals Div. of Kvaerner U.S., Inc. v. Commercial Union Ins. Co.*, 908 A.2d 888, 897 (Pa. 2006) (“The interpretation of an insurance contract is a question of law that we will review *de novo*”).

Our inquiry is straightforward. We look first to the terms of the policy which are a manifestation of the “intent of the parties.” *Baumhammers*, 938 A.2d at 290. “When the language of the policy is clear and unambiguous, we must give effect to that language.” *Id.* (quoting *Kvaerner*, 908 A.2d at 897). “However, when a provision in the policy is ambiguous, the policy is to be construed in favor of the insured” *Id.* (quoting *Kvaerner*, 908 A.2d at 897). Next, we compare the terms of the policy to the allegations in the underlying claim. “It is well established that an insurer’s duties under an insurance policy are triggered by the language of the complaint against the insured.” *Kvaerner*, 908 A.2d at 896.³ “In determining the existence of a duty to defend, the factual allegations of the underlying complaint against the insured

² The District Court exercised diversity jurisdiction under 28 U.S.C. § 1332, and we have jurisdiction over the final order of the District Court pursuant to 28 U.S.C. § 1291.

³ Although this action involves both the duty to defend and the duty to indemnify, we are concerned primarily with the former which is broader than the latter. *Kvaerner*, 908 A.2d at 896 n. 7; see *General Accident Ins. Co. of America v. Allen*, 692 A.2d 1089, 1095 (Pa. 1997) (“duty to defend is separate from and broader than the duty to indemnify, [though] both duties flow from a determination that the complaint triggers coverage”). A finding that the duty to defend is not present will preclude a duty to indemnify. *Kvaerner*, 908 A.2d at 896 n. 7. “Thus, if [Nationwide] does not have a duty to defend [CPB] in this suit, neither does it have the duty to indemnify.” *Id.*

are to be taken as true and liberally construed in favor of the insured.” *Frog, Switch & Mfg. Co., Inc. v. Travelers Ins. Co.*, 193 F.3d 742, 746 (3d Cir. 1999).

Thus, we look to the language of the policy “to determine in which instances [it] will provide coverage, and then examine [Rexall’s counterclaim] to determine whether the allegations set forth therein constitute the type of instances that will trigger coverage.” *Kvaerner*, 908 A.2d at 897. If we conclude that a “single claim in a multi-claim lawsuit is potentially covered, the insurer must defend all claims until there is no possibility that the underlying plaintiff could recover on a covered claim.” *Frog*, 193 F.3d at 746. Because it is clear that the underlying complaint alleges property damage as that term is used in the policy, this appeal turns on whether the alleged breach is an occurrence.

A. Claims Based on Faulty Workmanship.

In *Kvaerner*, the Supreme Court of Pennsylvania interpreted policy language identical to that at issue here. *See* 908 A.2d at 897 (policy defined “occurrence” as “an accident, including continuous or repeated exposure to substantially the same or general harmful conditions”). The court noted that the “key term in the ordinary definition of ‘accident’ is ‘unexpected.’” *Id.* at 898. There, the underlying claim, filed by Bethlehem Steel Corporation, alleged that the insured failed to construct a coke oven battery that met the agreed-upon contract specifications. *Id.* at 891. Bethlehem sought damages for breach of contract and breach of warranty. *Id.* The court characterized the claim as one for “faulty workmanship,” and held that “the definition of ‘accident’ required to establish an ‘occurrence’ under the polic[y] cannot be satisfied by claims based upon faulty workmanship.” *Id.* at 899. Perhaps recognizing the *Kvaerner* court’s logic, CPB concedes that Rexall’s claim that it provided defective chondroitin, without more, would not trigger coverage. *See* Appellant’s Br. at 12, 24. CPB is correct – Rexall’s claim that CPB delivered chondroitin of defective quality is an allegation of faulty workmanship that is not covered by the policy, although the workmanship involved here is a failure to perform quality control as to the product to be delivered rather than a failure to build a coke oven to the proper specifications. *See Kvaerner*, 908 A.2d at 899.

CPB argues, however, that because Rexall's action alleges consequential damages, it comes within the ambit of the policy. That argument is unpersuasive. The precise holding of *Kvaerner* is limited to claims that "aver[] only property damage from poor workmanship to the work product itself," 908 A.2d at 900, but the foundation of that holding is that claims for faulty workmanship "simply do not present the degree of fortuity contemplated by the ordinary definition of 'accident' or its common judicial construction in this context." *Id.* at 899. In other words, it is largely within the insured's control whether it supplies the agreed-upon product, and the fact that contractual liability flows from the failure to provide that product is too foreseeable to be considered an accident. *See id.* Here, although the delivery of defective chondroitin is not considered an accident, *see id.*, CPB argues that Rexall's use of that product should be considered one. That distinction is inapposite. It is certainly foreseeable that the product CPB sold would be used for the purpose for which it was sold. Otherwise, Rexall would lack a claim for consequential damages. *See Ferrer v. Trustees of Univ. of Pennsylvania*, 825 A.2d 591, 610 (Pa. 2002) (To prove consequential damages from breach of contract, plaintiff must establish that "(1) they were such as would naturally and ordinarily result from the breach, or (2) they were reasonably foreseeable and within the contemplation of the parties at the time they made the contract, and (3) they can be proved with reasonable certainty").⁴ Thus, "the degree of fortuity" here is no

⁴ Pennsylvania adheres to the Uniform Commercial Code. *See* 13 Pa.C.S.A. § 1101, et seq., which likely applies to the transaction that gave rise to the underlying claim. *See id.* at §§ 2102, 2104. The U.C.C. has similar requirements for consequential damages.

Consequential damages resulting from the breach of the seller include:

- (1) any loss resulting from general or particular requirements and needs of which the seller at the time of contracting had reason to know and which could not reasonably be prevented by cover or otherwise; and

different than that involved in *Kvaerner*, 908 A.2d at 898.

The Superior Court of Pennsylvania, when confronted with an argument similar to the one that CPB makes here, reached the same conclusion. *See Millers Capital Ins. Co. v. Gambone Bros. Dev. Co.*, 941 A.2d 706 (Pa. Super. Ct. 2008); *see also Nationwide Mut. Ins. Co. v. Buffetta*, 230 F.3d 634, 637 (3d Cir. 2000) (“opinions of intermediate appellate state courts are not to be disregarded by a federal court unless it is convinced by other persuasive data that the highest court of the state would decide otherwise” (quotations and citations omitted)). In *Millers Capital*, the insured was a housing developer, and the plaintiffs in the underlying action alleged that faulty construction resulted in severe leaking which damaged the interior of their homes. 941 A.2d at 713. The insured conceded that “*Kvaerner* stands for the broad principle that an insurance claim under an occurrence based GCL policy that defines the ‘occurrence’ as an accident cannot be premised on a claim of faulty workmanship.” *id.* at 713, but contended that the underlying action “involve[d] claims for ancillary and accidental damages caused by the resulting water leaks to . . . the home interiors,” and that those claims alleged “an ‘occurrence’ even though the damage to the” home exterior did not. *Id.* The Superior Court did “not see any merit in the distinction [the insured] attempt[ed] to create.” *Id.* Instead, the Superior Court interpreted the *Kvaerner* decision as stating that “natural and foreseeable acts . . . which tend to exacerbate the damage, effect, or consequences caused *ab initio* by faulty workmanship also cannot be considered sufficiently fortuitous to constitute an ‘occurrence’ or ‘accident’ for the purposes of an occurrence based CGL policy.” *Id.* That reasoning applies equally here.

(2) injury to person or property
proximately resulting from any breach
of warranty.

13 Pa. C.S.A. § 2715(b); *see id.* at § 2313(a)(2) (“Express warranties by the seller are created as follows . . . [a]ny description of the goods which is made part of the basis of the bargain creates an express warranty that the goods shall conform to the description”).

B. Breach of Contract is Not an Occurrence.

In any event, "Pennsylvania law does not recognize the applicability of a general liability policy to breach of contract and breach of warranty claims." *Pennsylvania Mfrs.' Ass'n Ins. Co. v. L.B. Smith, Inc.*, 831 A.2d 1178, 1181 (Pa. Super. Ct. 2003); see *Freestone v. New England Log Homes, Inc.*, 819 A.2d 550, 553 (Pa. Super. Ct. 2003); *Snyder Heating Co. v. Pennsylvania Mfrs.' Assoc. Ins. Co.*, 715 A.2d 483, 487 (Pa. Super. Ct. 1998). "The purpose and intent of a general liability insurance policy is to protect the insured from essentially accidental injury to the person or property of another rather than coverage for disputes between parties to a contractual undertaking." *L.B. Smith*, 831 A.2d at 1181.

CPB argues that because the Supreme Court of Pennsylvania has not specifically held that actions for breach of contract are not covered by CGL policies in Pennsylvania, the issue remains open and coverage should not be denied on that basis. "In predicting how the highest court of the state would resolve the issue, we must consider 'relevant state precedents, analogous decisions, considered dicta, [and] scholarly works . . .'" *Buffetta*, 230 F.3d at 637 (quoting *McKenna v. Ortho Pharm. Corp.*, 622 F.2d 657, 663 (3d Cir. 1980)).

Sitting *en banc* in *Redevelopment Authority of Cambria County v. International Insurance Company*, 685 A.2d 581 (Pa. Super. Ct. 1996), the Superior Court of Pennsylvania held that a CGL policy "do[es] not provide coverage for claims in [an] underlying action [that] arise out of and relate to the contract between the parties." *Id.* at 592. That language has since become a well-established principle of insurance interpretation in Pennsylvania. See *L.B. Smith*, 831 A.2d at 1181.

Although the *Kvaerner* decision did not expressly adopt the *Redevelopment Authority* holding, it did offer several indications that, if presented with the question of whether breach of contract claims are covered by a CGL policy, the Supreme Court of Pennsylvania would reach the same conclusion. First, *Kvaerner* cites *Snyder Heating* and approvingly describes the decision as follows: "The [*Snyder Heating*] court held that there was no

coverage under the language of the CGL policy because the complaint set forth solely claims for breach of contract.” 908 A.2d at 898. Second, *Kvaerner* states that “[t]he application and limitations of CGL policies were aptly explained in a seminal law review article,” and then quotes the article which states, in relevant part, that: CGL “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.” *Id.* (quoting Roger C. Henderson, [*Insurance Protection for Products Liability and Completed Operations; What Every Lawyer Should Know*], 50 Neb. L. Rev. 415, 441 (1971)); see 9A Lee R. Russ & Thomas F. Segalla, *Couch on Insurance* § 129:16 (2008) (using same language). Finally, the Court expressed reluctance to convert a CGL “policy for insurance into a performance bond.” *Kvaerner*, 908 A.2d at 899, which echoes the Superior Court’s reticence to “convert a [CGL] policy into a professional liability policy or a performance bond” by recognizing coverage for breach of contract. *Redevelopment Authority*, 685 A.2d at 592.

We are, therefore, confident that the Supreme Court of Pennsylvania would conclude that an underlying claim alleging breach of contract would not trigger coverage under a CGL policy. See *Snyder Heating*, 715 A.2d at 487. The District Court properly concluded that Rexall’s allegations against CPB “are based in contract and do not arise from covered ‘occurrences.’” (Appendix at 19.) See *Snyder Heating*, 715 A.2d at 487 (citing *Phico Ins. Co. v. Presbyterian Med. Servs. Group*, 663 A.3d 753, 757 (Pa. Super. 1995) (“important difference between contract and tort actions is that the latter lie from a breach of duties imposed by law as a matter of social policy while the former lie from the breach of the duties imposed by mutual consensus agreements between particular individuals”).⁵

⁵ In *Keystone Filler & Mfg. Co., Inc. v. American Mining Ins. Co.*, 179 F. Supp. 2d 432 (M.D. Pa.), *aff’d mem.* 55 Fed Appx. 600 (3d Cir. 2002), a district court applying Pennsylvania law to very similar facts reached the same conclusion in a persuasive decision. There, the insured made a carbon-based product from finely-ground coal, and sold it to a company that used the product

C. Contractual Liability Exclusion.

Finally, even if the underlying claim alleged an occurrence covered by the policy, it fits within the contractual liability exclusion. That exclusion states that the "insurance does not apply to . . . 'property damage' for which the insured is obligated to pay damages by reason of the assumption of liability in a contract or agreement." (Appendix at 135). The *Snyder Heating* court interpreted the same contract language, 715 A.2d at 485, and concluded that "the CGL policy clearly excludes from coverage breaches of contract; the policy language provides that the insurance contract will not apply to [the insured's] failure to perform a contract or agreement in accordance with its terms." 715 A.2d at 487.

III.

For the foregoing reasons, we will affirm the District Court's grant of summary judgment in favor of Nationwide.

as a component of plastisol (a material used in automobile filters). 179 F. Supp. 2d at 436. The insured's product contained oversized particles and damaged a certain amount of plastisol, rendering it useless. *Id.*

The court noted that the "rule . . . that there is no 'occurrence' if the underlying claim is one merely for breach-of-contract[] has been followed by numerous state and federal courts sitting in Pennsylvania." *Id.* at 440; *see id.* (cataloguing cases). It went on to state that the insured's product "was manufactured in a way that did not conform to [the purchaser's] requirements for the manufacture of plastisol" and that the underlying claim stemmed from a "breach[] [of] duty imposed by mutual consensus with" the purchaser. *Id.* at 442-43. Therefore, it did not trigger coverage. *Id.*