INCORPORATION DOCTRINE AS AN ALTERNATE METHOD OF ESTABLISHING PROPERTY DAMAGE

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Consider the following scenario: undisputed building code violations, i.e. improperly constructed shear and fire walls, put a building at risk of future collapse during high winds, earthquake or fire. Must a plaintiff wait until the building actually collapses or when total destruction occurs to claim tort compensation?

In its encyclopedic (forty-seven page) decision in *Aas v. Superior Court* (2000) 24 Cal.4th 627, the California Supreme Court in substance said yes and held that in tort claims arising from construction defects, any and all "evidence of construction defects that have not caused property damage" should be excluded at trial as a matter of law. *Id.*, 24 Cal 4th at 633-635, 653-654. After *Aas,* plaintiffs can no longer recover in tort against the developer, contractor and subcontractors who built their homes simply because the "alleged defects violate provisions of the applicable building codes intended to prevent harm to life, health and property." *Id.*, 24 Cal. 4th at 633. There must be property damage, i.e. "physical injury to property." *Id.,* 24 Cal.4th at 641.

Left unresolved in *Aas* was a critical issue: **How and when is property "physically injured" in order for a plaintiff to obtain tort damages?** Stated another way, when does "appreciable" physical damage – an "essential element of a negligence claim"-- occur under *Aas* to trigger compensable tort damages for construction defects? *Id*., 24 Cal.4th at 646.

CODE OF CIVIL PROCEDURE SECTION 28 DEFINES PROPERTY DAMAGE

Aas does not define "property damage, " nor does it otherwise provide any guidance for determining when compensable "property damage" occurs; it only refers to appreciable harm. Conspicuously omitted from the text of *Aas* is *Code of Civil Procedure* Section 28 (the original California definition of property damage, enacted in 1872 but rarely cited in subsequent case law), which defines "property damage" as follows: "An injury to property consists of depriving the owner of the benefit of it, which is done by taking, withholding, deteriorating or destroying it." Indeed, no California case has ever cited or discussed this statute in the context of a construction defect claim.

There is nothing in the plain text of the *Code of Civil Procedure* Section 28 or any reported case which prohibits its use expansively in construction defect cases or which otherwise limits or restricts its applicability. It is therefore puzzling that *Aas* never cited nor discussed this statute in the context of a tort action seeking damages for construction defects. [Prudent practitioners should do so.]

There is a reality check: plaintiffs who seek to use *Code of Civil Procedure*

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Section 28 as a way around the prohibitions of *Aas* may encounter a less than receptive judicial response to such an argument. Plaintiffs will also be hamstrung by the fact that the most perceptive post-*Aas* analysis of what constitutes "appreciable" damage is found in two depublished Courts of Appeal cases. *Mesa Vista Homeowners' Association v. Portland Cement Company* (2004) 118 Cal.App.4th 308; *Shekhter v. Seneca Structural Design, Inc.*(2004) 121 Cal.App.4th 1055. Practitioners who require citable precedent to argue a more precise definition or factual context for "appreciable " harm must await a published Court of Appeal decision or a California Supreme Court decision. In the meantime, however, *Mesa Vista* and *Shekhter* offer tantalizing clues as to how these arguments can be framed in prosecuting construction defect cases which seek tort compensation for "property damage" post-*Aas* and which may someday find their way to the California Supreme Court.

THE SPECIAL RELATIONSHIP AS A "WILD CARD" FOR PHYSICAL INJURY.

Any discussion of "appreciable" harm as the benchmark for "property damages" in *Mesa Vista* or in any other construction defect case post-*Aas* must first begin with *Biakanja v. Irving* (1958) 49 Cal.2d 647. In that case, the California Supreme Court held that an intended beneficiary of a failed testamentary gift could recover negligence damages from a notary public who practiced law without a license, prepared a defective will and failed to have it properly solemnized. *Id.,* at 49 Cal. 2d at 650.

In imposing third-party, non-privity liability for negligence, the *Biakanja* court articulated a six-pronged test to determine the existence of a legal duty which has proved to be a landmark, influential test in California tort law: "the extent to which the transaction was intended to affect the plaintiff, the foreseeability of harm to him, ***the degree of certainty that the plaintiff suffered injury,*** the closeness of the connection between the defendant's conduct and the injury suffered, the moral blame attached to the defendant's conduct, and the policy of preventing future harm." *Id.* (emphasis added)

The third prong of the *Biakanja* test was a critical ingredient of *Aas. (Aas, supra,* 24 Cal.4th at 637-638, 643-644). *Aas*' concept of "appreciable harm" was partially grafted from appreciable "harm" in asbestos cases: "Physical injury resulting from asbestos contamination [when asbestos fibers become airborne, i.e. friable], not the mere presence of asbestos, must have occurred before a cause of action for strict liability or negligence can accrue in an asbestos-contaminated building case…" *San Francisco Unified School District v. W.R. Grace & Co.* (1995) 37 Cal.App.4th 1318, 1325, 1330. As will be discussed below, however, other cases which discuss asbestos as "physical damage" in the context of insurance coverage only require incorporation or presence in the structure for physical damage to occur. *Armstrong v. Aetna* (1996) 45 Cal.App.4th 1, 7. Indeed, what seems most likely in future California decisions is that the definition of "appreciable" harm as the trigger of physical injury to property to recover tort damages will undergo further fine tuning and will "expand" to include "damage" far less extensive

than the collapse of a building, such as microscopic cracking.

APPRECIABLE HARM: COUNTING THE ANGELS THAT CAN DANCE ON THE HEAD OF A PIN

The trend toward expanding the definition of "appreciable" harm to enhance plaintiff recovery is best illustrated in *Mesa Vista*, now depublished. In that case, the Fourth District Court of Appeal affirmed a trial court judgment in favor of a plaintiff HOA which had as its central finding that submicroscopic damage from sulfate attack to concrete, although "latent," was sufficiently "appreciable" under *Aas* to cause additional damage and ultimate disintegration over time unless repaired (the damage was not visible with optical microscopes, but could be observed with a scanning electron microscope). *Id.,* 118 Cal.App.4th at 311. If anything, the situation in *Mesa Vista,* although marked by "submicroscopic" damage, was worse than *Aas: "*The situation before us is significantly different than *Aas.* The foundations are decaying, the condition of the foundations will worsen, the foundations will deteriorate. Moreover, we are talking about foundations of structures. Logic would indicate that as the foundations disintegrate there may indeed be realistic risk of structural failure." *Id.*, at 333.

In *Mesa Vista,* size of damage did not count. What really mattered was the potential devastation to a critical component caused by submicroscopic cracking of concrete which had the destructive potential of a "ticking time bomb." The patent threat of future physical harm was "appreciable" enough to trigger property damage as the basis for compensation of tort damages for construction defects.

In *Shekhter,* a depublished case from 2005*,* the owners of an apartment complex sued a structural engineering firm and a general contractor for construction defects arising from, among other things, post-Northridge earthquake repairs, i.e. an inadequate redesign plan. The entire west half of a building collapsed, while the east half remained standing.

Shekhter was a pleading case and one of the issues decided on appeal was whether the plaintiff could, under *Aas,* allege negligent performance of a contract without violation of an independent duty and still recover tort damages. The plaintiffs contended that *Aas* was satisfied because the complaint alleged property damage, including "substantial and progressive cracking" in the elevated decks of the apartment complex due to improper repairs. The Second Appellate District agreed: "We conclude that the defendants misconstrue *Aas*. In our view, requiring damage to property other than the repaired structure would improperly apply principles applicable to defective products to a case premised upon negligent design and engineering. Nothing in *Aas* requires that result."

Indeed, *Shekhter* cited *Aas'* own language for the proposition that "persons whose homes 'suffered serious damage from cracking caused by ill-designed foundations'…could sue the construction lender as the joint venturer of the developer on the theory that it owed the plaintiffs a duty to 'exercise reasonable care to protect them from damages caused by major structural defects'" *Aas*,

supra, 24 Cal.App.4th at 648, fn. 12,citing *Connor v. Great Western Savings* (1968) 69 Cal. 2d 850. Secondly, *Shekhter* applied *Biakanja,* in particular its third factor ("the degree of certainty that the plaintiff suffered injury"), to show that, unlike *Aas, the Shekhter* plaintiffs adequately pleaded, and thus could attempt to prove, an injury to property that was decidedly "appreciable", "non-speculative" and "present," which *Aas* held to be a "fundamental prerequisite" to a tort claim. *Id.,* 24 Cal.4th at 646.

While plaintiffs seeking to establish physical damage to property as the prerequisite to a viable tort claim cannot cite *Mesa Vista* or *Shekhter* directly in support of their arguments, nothing prevents them from giving careful consideration to the way the arguments in those cases used *Aas* effectively to expand and clarify the definition of "appreciable" harm to support that tort claim..

Another fruitful approach in establishing "property damage" post-*Aas* is to re-examine a well-settled line of authority cited and discussed extensively by *Aas* in its exhaustive historical survey of California tort law: Insurance cases, which do not under *Aas* adjudicate "rule[s] of tort liability" but rather interpret "contractual language in an insurance policy" (*Aas*, p. 642, fn. 10), nevertheless assist the tort claimant by consistently holding that resulting physical damage to structures from construction defects constitutes a covered claim under a liability insurance policy. Such an examination will reveal a critical concept, never repudiated or disapproved in *Aas*, that creates a viable framework for proving "property damage" in a construction defect claim: the "incorporation" doctrine.

The majority in *Aas* has an equivocal attitude about *incorporation*. On the one hand, it is dismissive:

> "The concurring and dissenting justices would hold that property damage occurs when a defective component is incorporated into a house." *Id.* On the other hand, however, it recognizes and does not dispute the fact that, at least with respect to products liability cases, "[O]ver time, the concept of recoverable physical injury or property damage expanded to include damage to one part of a product caused by another, defective part." *Aas*, *supra,* 24 Cal.4th at 641.

Indeed, notwithstanding the less than enthusiastic language cited above, neither *Aas* nor any other case expressly repudiates or limits the so-called "*incorporation doctrine*" as a rule of tort liability, so long as some "physical damage" was established.

Long before *Aas* was decided, California courts had adopted a far more favorable attitude toward "incorporation" in the context of proving physical damage to property as a prerequisite for liability insurance coverage in construction cases.

ADOPTING *INCORPORATION* AS PHYSICAL INJURY FROM INSURANCE PROPERTY DAMAGE CASES

In *Aas*, Justice Mosk's dissenting opinion provided a cogent common sense approach for the recovery for defects that are incorporated into structures but have not yet suffered failure:

> "Because I believe it is economically efficient to provide plaintiffs with a remedy to repair conditions that allegedly pose a serious safety hazard, I respectfully dissent from the majority's contrary conclusion. I believe the Supreme Court of Indiana pointed out quite well the inefficiency inherent in the economic loss rule as applied to such conditions: "If there is a defect in a stairway and the purchaser repairs the defect and suffers an economic loss, should he fail to recover because he did not wait until he or some member of his family fell down the stairs and broke his neck?" (*Barnes v. Mac Brown & Company, Inc.* (1976) 264 Ind. 227, 230 [342 N.E.2d 619, 621].) Thus, to answer the majority's rhetorical question, "What harm?" (maj. opn., ante, at p. 646), I would say, the harm that will arise when homeowners, believing, as humans are wont to do, that injury only befalls others, fail to repair hazardous conditions." *Aas*, supra, 24 Cal.4th at 673.

Justice Mosk observed that many Californians live in modern mass-market housing and that builders cutting corners is a prevailing problem in the construction industry:

> "The descriptions of construction defects in the numerous letter briefs we have received from the construction law bar suggest as much. The briefs describe the willingness of some developers to evade or stint the Uniform Building Code's safety requirements, among other elements. In this context, the majority's result is likely, as one litigant put it, to create "an invitation for developers, general contractors and subcontractors to ignore [construction] Code requirements when building and developing homes." *Id.*, 24 Cal.4th at 673-674.

Justice Mosk observed that the majority opinion tacitly acknowledged the risks of inefficiency their rule generates:

> "[T]o require builders to pay to correct defects as soon as they are detected rather than after property damage or personal injury has occurred might be less expensive. On the other hand, such a rule would likely increase the cost of housing by an unforeseeable amount as builders raised prices to cover the increased risk of liability." (Maj. opn., ante, at p. 649.) *Id.*, 24 Cal.4th at 674.

As Justice Mosk explained and as codefendant Lyon argued in the alternative in the Court of Appeal brief, the theory advanced in Judge Posner's opinion in *Eljer Mfg., Inc. v. Liberty Mut. Ins. Co.* (7th Cir. 1992) 972 F.2d 805, provides, by analogy, additional and separate support for recognition of a right to recover repair costs. He explained that he would adopt a view similar to that of Judge Posner in *Eljer*:

> "Interpreting comprehensive general liability insurance policies that defined the term "property damage" as " 'physical injury to . . . tangible property' " (

Id. at p. 807), but considering facts similar to those of this case, Posner wrote that **physical injury to property occurs when it "results from . . . physical linkage**, as when a potentially dangerous product is incorporated into another and, because it is incorporated and not merely contained (as a piece of furniture is contained in a house but can be removed without damage to the house), *must* be removed, at some cost, in order to prevent the danger from materializing. There is an analogy to fixtures in the law of real and personal property--improvements to property that cannot be removed without damaging it. (See, e.g., *UCC* § 9-313." *Id.* at p. 810, italics added.) I italicize *must* because the word prefigures cautionary language in the *Eljer* opinion. The risk of harm--in *Eljer*, the "expected failure rate" (*Eljer*, *supra*, 972 F.2d at p. 812)--"must be sufficiently high . . . to induce a rational owner to replace it" (*ibid.*) or repair it." *Id.* (emphasis added) *Aas.* At 674.

Justice Mosk favored the *Eljer* approach because it obviated the need to consider the six *Biakanja* factors (*Biakanja v. Irving* (1958) 49 Cal. 2d 647, 650 [320 P.2d 16, 65 A.L.R.2d 1358]; see *Ott v. Alfa-Laval Agri, Inc.* (1995) 31 Cal. App. 4th 1439, 1449 [37 Cal. Rptr. 2d 790])--although even under those factors Justice Mosk believed, as did the Chief Justice's dissenting opinion, that damages are sufficiently ascertainable to justify liability:

"The rule I favor would state that **property damage occurs** when what may be termed "fixtures" for purposes of discussion, inseparable from the structure of the houses or condominiums and inaccessible for repair without destroying existing features, **are negligently built or installed**. (Cf. *Cal. U. Com. Code*, § 9102, subd. (a)(41).) [2]" *Id.* (emphasis added)

In his dissenting opinion in *Aas,* Chief Justice George went back to the genesis of California law dealing with deficiencies in construction. In *Connor v. Great Western Sav. & Loan Assn.* (1968) 69 Cal. 2d 850 [73 Cal. Rptr. 369, 447 P.2d 609, 39 A.L.R.3d 224] (*Connor*), Chief Justice Roger Traynor, upheld a negligence action by homeowners against a lending institution that had financially backed and extensively controlled a new housing development, and observed that

"the usual buyer of a home is ill-equipped with experience or financial means to discern . . . structural defects." (*Id*., at p. 867.) The Connor opinion rejected as "conjectural claims" assertions that recognizing a duty on the part of the defendant to the homeowners would "increase housing costs, drive marginal builders out of business, and decrease total housing at a time of great need" (*ibid.*), observing that "[i]n any event, there is no enduring social utility in fostering the construction of seriously defective homes. If reliable

[2] As Justice Mosk observed, " *Eljer* relied on Illinois law in interpreting the insurance policies. The Appellate Court of Illinois later rejected its interpretation. (*Travelers Ins. Co. v. Eljer Mfg., Inc*. (1999) 307 Ill.App.3d 872 [241 Ill.Dec. 178, 718 N.E.2d 1032, 1039-1041], review granted (1999) 186 Ill.2d 590 [243 Ill.Dec. 569, 723 N.E.2d 1170].) Leaving aside the policies' definition of 'property damage,' however, *Eljer*'s conclusion favoring the so-called incorporation doctrine--that property damage occurs when defective installation or construction requires that walls be torn out or the like--is persuasive and should be applied here." *Id*., 24 Cal.4th 675, f.n. 2.

construction is the norm, the recognition of a duty on the part of tract financiers to home buyers should not materially increase the cost of housing or drive small builders out of business." (*Id.*, at pp. 867-868; *Id.*, 24 Cal. 4th at 654 (emphasis added).

Chief Justice George observed that Justice Traynor in *Connor* was concerned that "**a home is not only a major investment for the usual buyer but also the only shelter he has**. *Hence it becomes doubly important to protect him against structural defects that could prove beyond his capacity to remedy*." (*Id.*, at p. 867, italics added.) *Id.*, 24 Cal.4th at 654-655.

> "As implied in the above italicized observation, tort law offers the most effective, and often the only realistic, nonstatutory remedy for consumers in this area. Although technically available to at least some of the plaintiffs in this and similar litigation, contract or warranty claims in this setting are difficult to prove and to enforce, and our decisions have recognized that problems with privity, disclaimers inserted into contracts by developers or contractors, and notice requirements, often frustrate the ability to recover on contract or warranty theories. (See, e.g., *Greenman v. Yuba Power Products, Inc.* (1963) 59 Cal. 2d 57, 61 [27 Cal. Rptr. 697, 377 P.2d 897, 13 A.L.R.3d 1049] [notice requirement under implied warranty is a " 'booby-trap for the unwary' " and " 'consumer[s are] seldom "steeped in the business practice which justifies the rule" ' "]; *Anthony v. Kelsey-Hayes Co*. (1972) 25 Cal. App. 3d 442, 448 [102 Cal. Rptr. 113] [lack of privity defeats implied warranty claim].) As observed in *Kriegler v. Eichler Homes, Inc*. (1969) 269 Cal. App. 2d 224, 228 [74 Cal. Rptr. 749] (*Kriegler*), because the purchaser of a " 'development house' " " 'has no real competency to inspect on his own, his actual examination is, in the nature of things, largely superficial, and his opportunity for obtaining meaningful protective changes in the conveyancing documents prepared by the builder vendor is negligible. . . .' [P] 'Buyers of mass produced development homes are not on an equal footing with the builder vendors and are no more able to protect themselves in the deed than are automobile purchasers in a position to protect themselves in the bill of sale.' " *Id.,* 24 Cal.4th at 655.

Accordingly, as Chief Justice Traynor recognized in *Connor, supra,* 69 Cal. 2d 850, and as Justice Mosk trenchantly observed in his *Aas* dissent, "the inadequacy of contract and warranty law properly should inform our consideration of the role and use of tort law in this context. Chief Justice George reflects in footnote 11 of *Aas* (p. 645) that Justice Mosk is on the right track when he asserts, as codefendant Lyon argued in the Court of Appeal, the incorporation theory advanced by Judge Posner in *Eljer.*

JUDGE POSNER'S RATIONALE FOR THE INCORPORATION DOCTRINE IN *ELJER*

Eljer, coupled with Justice Mosk's vigorous and articulate dissent in *Aas,* offers perhaps the most comprehensive and focused strategy for plaintiffs in construction defects to argue incorporation as the basis for physical damage to

property as the predicate for a tort damage claim.

In *Eljer*, the issue was: If a manufacturer sells a defective product or component for installation in the real or personal property of the buyer, but the defect does not cause any tangible change in the buyer's property until years later, can the installation itself nonetheless be considered a "physical injury" to that property? *Id.*, 972 F.2d at 807.The answer in *Eljer* was yes, using the same reasoning as that in *Armstrong* and *Mesa Vista*.

In *Eljer,* the court likened the defective product or component to a time bomb placed in an airplane luggage compartment, harmless until it explodes, or like a silicone breast implant that is harmless until it leaks. Or like a defective pacemaker which is working fine now but will stop working in an hour. *Id*. Armed with these analogies, the court then asked: Is the person or property in which the defective product is implanted or installed physically injured at the moment of implantation or installation--in a word, incorporation--or not until the latent harm becomes actual? *Id*.

The product at issue in *Eljer* was a plumbing system, called "Qest," that appellant Eljer's U.S. Brass subsidiary manufactured and sold to plumbing contractors all over the United States between 1979 and 1986. Between a half million and three-quarters of a million Qest systems were installed in houses and apartments, invariably behind walls or below floors or above ceilings, so that the repair or replacement of the unit required breaking into walls, floors, or ceilings. *Id.*

Eljer brought the lawsuit to establish that the **physical injury to the property of the buyer of a Qest system occurs when the system is installed** in the buyer's house or apartment, not when it begins to leak or is replaced or is recognized to have reduced the value of the buyer's property. If this was right, essentially all the "property damage" inflicted by the defective systems occurred during the years in which Liberty's insurance policies were in force, because those were the years in which the systems were sold and installed. *Id.,* 972 F.2d at 808.

The central issue in *Eljer*--when if ever the incorporation of one product into another can be said to cause physical injury--pivoted on a conflict between the connotations of the term "physical injury" and the objective of insurance. *Id.* Judge Posner's analysis of "physical injury" is a model of lucidity and common sense: The central meaning of the term as it is used in everyday English--the image it would conjure up in the mind of a person unschooled in the subtleties of insurance law—was of a harmful change in appearance, shape, composition, or some other physical dimension of the "injured" person or thing. If water leaks from a pipe and discolors a carpet or rots a beam, **that is physical injury**, perhaps beginning with the very earliest sign of rot--the initial contamination (also, as *Armstrong* noted, an important question in asbestos cases). *Id.*, 972 F,2d at 809.

For Judge Posner, the ticking time bomb, in contrast, did not injure the structure in which it is placed, in the sense of altering the structure in a harmful, or

for that matter in any, way--until it exploded. Posner wrote that these distinctions had little to do with the objectives of parties to insurance contracts. The purpose of insurance is to spread risks and by spreading cancel them. Most people are risk averse, and will therefore pay premiums to avoid a small probability of a large loss.

As Judge Posner observed, once a risk becomes a certainty--once the large loss occurs--insurance has no function. The last point at which a Qest plumbing system had an *insurable risk of being defective* and causing harm was when it was installed. When it starts to leak it is too late; the risk has turned into a certainty and cannot be spread by being insured.

For the individual homeowner, however, **there is still uncertainty** as to whether and when his Qest will leak, so he may still be able to buy insurance against such an eventuality, though the premium will be very high because the risk is very great. Posner noted that *Eljer*, was liable for all leaks traceable to the defective plumbing system (as distinct from installation errors), and that the pooling of the risks from the individual homeowners produced a near certainty of losses in excess of 100 million dollars.

Judge Posner discussed the origins of liability insurance policies, in particular the ISO forms. That analysis showed that the term “physical injury” was intended to distinguish between **physical** and **nonphysical injuries** rather than to distinguish between **injuries** and **non-injuries**. The 1966 version of the General Comprehensive Liability Insurance policy form had defined "property damage" as "injury to or destruction of tangible property."

The 1973 ISO revision redefined “physical injury.” The first part of the new definition was the old definition with "physical" prefixed to "injury" to distinguish the two parts. Both cover injury, but the second part covers injury which is not "physical" because there is no physical touching of the tort victim's property. Significantly, Posner observed that there was no intent by the ISO to curtail liability in cases involving **physical touching**, as where a defective water system is installed in a house. *Id.,* 972 F.2d at 810. Under Judge Posner’s analysis, there were in effect two competing definitions of “physical injury”:

> “One, which the insurers want us to adopt, is an **injury that causes a harmful physical alteration** in the thing injured.
>
> The other, which is what the draftsmen of the Comprehensive General Liability Insurance policy apparently intended and what rational parties to such a policy would intend in order to make the policy's coverage real and not illusory, **is a loss that results from physical contact, physical linkage**, as when a potentially dangerous product is incorporated into another and, because it is incorporated and not merely contained (as a piece of furniture is contained in a house but can be removed without damage to the house), must be removed, at some cost, in order to prevent the danger from materializing”. *Id.* (emphasis added)

As Judge Posner saw it, there is an analogy to fixtures in the law of real and

personal property--improvements to property that cannot be removed without damaging it. See, e.g., UCC § 9-313. *Id at 810.*

Judge Posner cautioned that every time a component part fails, the resulting injury should not have to be backdated to the date of installation or incorporation to demonstrate compliance with the ISO definition. The expected failure rate must be sufficiently high to mark the product as defective--**sufficiently high**, as is alleged to be the case regarding the Qest plumbing system, **to induce a rational owner to replace it before it fails**, so likely is it to fail. That condition was satisfied in *Eljer. Id.,* 972 F.2d at 812.

Judge Posner boldly held that **installation** of the defective plumbing systems triggered insurance coverage in the polybutylene plumbing disputes. He interpreted physical injury to surpass the everyday connotation: "the term [physical injury] was intended to distinguish between *physical* and *nonphysical* injuries rather than to distinguish between *injuries* and *noninjuries*. Thus, there were two possible ways to interpret the phrase "**physical** injury" and "physical **injury**." Accordingly, he placed the emphasis on the word "injury." "Physical injury" is "a loss that results from physical contact.

Judge Posner concluded the *Eljer* opinion by noting that "the word 'physical' in the definition of property damage serves an important limiting purpose even if it is not interpreted to require a change in the property with which the tortfeasor comes in contact." Also, because of his analysis of the drafting history of the CGL policy and the probable understanding of the parties, Judge Posner was "persuade [d]... that the **incorporation of a defective product into another product inflicts physical injury** in the relevant sense on the latter **at the moment of incorporation**--here, the moment when the defective Qest systems were installed in homes." *Id.* 972 F 2d. at 814

GENESIS OF THE INCORPORATION DOCTRINE IN CALIFORNIA.

More than thirty years before, California had adopted the incorporation theory. *In Geddes & Smith, Inc., v. St. Paul Mercury Indemnity Co*. (1959) 51 Cal.2d 558, the Supreme Court adopted the "incorporation doctrine" for the first time.

Geddes, a building contractor, ordered 760 aluminum doors, door jambs, and attached hardware from Aluminum Products. After Geddes installed the doors in tract homes, defects appeared in some of the doors within a few days and in others after various periods of time ranging up to six months. Some of the doors sagged on their hinges and dragged on the floors. Some went out of shape. Parts of some of the doors fell out. Some doors could not be closed and others that were closed became locked in place and could not be opened. *Id.,* 51 Cal.2d at 560.

Plaintiff notified Aluminum Products, which undertook to supply other doors. Many of the new doors had the same defects as the old. Some were found damaged when received by plaintiff. Aluminum Products shipped a total of 2,604 doors before enough suitable doors were obtained, and plaintiff was engaged in handling, storing, repairing, removing and installing doors for over a year. *Id.,* 51 Cal.2d at 560-561.

Plaintiff sued Aluminum Products alleging breach of warranty and negligence for expenses incurred in removing, installing, repairing, storing, and shipping the doors, as well as expenses incurred in office overhead during the time it was engaged in settling disputes, and loss of profit. Defendant, St. Paul Mercury, refused to defend on the ground that damage to the doors was excluded from coverage. Aluminum Products then undertook the defense of the action. *Id.*, 51 Cal.2d at 561. The trial court entered judgment on the complaint for plaintiff in the sum of $100,000 and costs against Aluminum Products. Plaintiff then brought an action against defendant to recover the amount of the judgment under the insurance policy issued by defendant to Aluminum Products. *Id.*

St. Paul Mercury contended that there was no injury to or destruction of property caused by accident. The *Geddes* court cited *Hauenstein* v. *Saint Paul-Mercury Indem. Co*., 242 Minn. 354 for the property damage proposition. In that case, the insured sold defective plaster that was used to plaster a house. The plaster shrank and cracked to such an extent that it was of no value and had to be removed so that the walls and ceilings could be replastered with a different material. Injury to the plaster itself was excluded from coverage. *Id.*, 51 Cal.2d at 565.

The *Hauenstein* court held, however, that **injury to the house had occurred** and was covered under a clause identical with Coverage C in the *Geddes* case:

> "No one can reasonably contend that the application of a useless plaster, which has to be removed before the walls can be properly replastered, does not lower the market value of a building. Although the injury to the walls and

ceilings can be rectified by removal of the defective plaster, nevertheless, the presence of the defective plaster on the walls and ceilings reduced the value of the building and constituted property damage. The measure of damages is the diminution in the market value of the building, or the cost of removing the defective plaster and restoring the building to its former condition plus any loss from deprival of use, whichever is the lesser." (68 N.W.2d at 125.)

In *Geddes*, the court found that the door failures were unexpected, undesigned, and unforeseen. Although it may have taken many months for all of the doors to fail and fall apart, it was clear that each door, when it failed, failed suddenly. At one moment it was a usable door, at the next it was not. Had the door failure resulted in direct physical injury to the houses, the accidental cause of the harm would be obvious, but other harms flowing from the door failures were likewise accidentally caused. Accordingly, the crucial issue was which, if any, of these harms were within the policy coverage. In *Geddes*, the Superme Court held that **removing defective doors** as a defective component of a house **was enough to allow indemnity for physical damage to the house**. *Id.* at 886.

ARMSTRONG RELIES ON THE INCORPORATION DOCTRINE AS SET FORTH IN *GEDDES* AND *ELJER*

In *Armstrong World Industries, Inc.v. Aetna Casualty and Surety Co. (1996)* 45 Cal.App.4th 1, the first appellate district breathed new life into the incorporation doctrine. *Armstrong* found liability insurance coverage for physical damage due to incorporation of asbestos ***without*** release of the fibers into the air. Incorporation without contamination was enough, unlike the decision in *San Francisco Unified School District v. W.R. Grace & Co.,* 37 Cal.App.4th *supra*, where the court held the fibers had to be *friable* or released from the ceiling. Id., 45 Cal.App. 4th at 7.

In *Armstrong*, the underlying complaints revealed that the presence of ACBM (asbestos containing building materials) might have various consequences to the building owner. The ACBM's posed a potentially serious health hazard to those who used the building in that asbestos fibers might be released into the air or onto building surfaces (walls, upholstery, fixtures, etc.) or settled releases might be disturbed and "reentrained" into the air. Whether or not the ACBM released asbestos fibers, the building owner might decide to remove or encapsulate the asbestos to eliminate the potential health risk. Alternatively, the building owner might incur costs for inspecting, assessing, maintaining and repairing in-place ACBMs'. Further,the value of the property might fall as a result of the presence of asbestos. *Id*., 45 Cal.App.4th at 87.

Beginning in the early 1980's, after the federal government started to voice concern about the safety of ACBM's, numerous lawsuits were brought against Armstrong and other asbestos producers for property damage to buildings in which ACBM's had been installed. There were 163 building cases, including a number of class actions, pending against Armstrong in courts across the country. Although the complaints advance various legal theories, the plaintiffs in the building cases

generally seek compensation for the sums they must expend to eliminate the alleged health hazard in their buildings and for the diminished value of their buildings resulting from the presence of asbestos. *Id.*, 45 Cal.App.4th at 87-88.

The *Armstrong* court began its discussion with the question of whether the injuries allegedly suffered by the building owners constituted "property damage" as defined by the insurance policies. Many of Armstrong's policies were standard CGL policies. The insuring agreements of the CGL policies obligated the insurers to pay "all sums which the insured shall become legally obligated to pay as damages because of . . . property . . . damage caused by an occurrence." *Id.*, 45 Cal.App.4th at 88.

> Since 1973, the standard CGL policy defined property damage as follows:
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> "i) physical injury to or destruction of tangible property which occurs during the policy period, including the loss of use thereof at any time resulting therefrom, or ii) loss of use of tangible property which has not been physically injured or destroyed provided such loss of use is caused by an occurrence during the policy period."

Before 1973, under the 1966 revision to the standard CGL occurrence policy, "**physical injury**" was not a necessary element of property damage; property damage was defined as "**injury** to or destruction of tangible property." Before 1966, the standard CGL policy had no requirement that the property be "tangible."

The trial court in *Armstrong* concluded that all claims, whether for release of asbestos fibers or for mere installation of ACBM, were for covered "property damage" under all of Armstrong's policies. The trial court reasoned that the release of asbestos fibers is an act of contamination that amounts to physical injury and, even without a release of fibers, the diminished value resulting from the incorporation of ACBM in a building constituted property damage. The Court of Appeals agreed: "We conclude that **even …when there have been no releases of asbestos fibers**, if Armstrong is held liable for the presence of ACBM, the injury to the buildings is a **physical one**." *Id.at* 45.

The court's ruling was based upon a factual analysis. Once installed, the ACBM's, (whether in the form of insulating pipe coverings, fireproof floor tile, accoustical ceiling finishes), is **physically linked with or physically incorporated** into the building and therefore physically affects tangible property. The court agreed with *Eljer* that the term "physical injury" covers "a loss that **results from physical contact** or physical linkage, as when a potentially dangerous product is **incorporated into another** and, because it is incorporated and not merely contained (as a piece of furniture is contained in a house but can be removed without damage to the house), must be removed, at some cost, in order to prevent the danger from materializing. (*Eljer Mfg., Inc. v. Liberty Mut. Ins. Co*. (7th Cir. 1992) 972 F.2d 805, 810 cert. den. (1993) 507 U.S. 1005 [123 L. Ed. 2d 267, 113 S. Ct. 1646] [defective plumbing systems](emphasis added); see also *American Motorists Ins. Co. v. Trane Co*. (7th Cir. 1983) 718 F.2d 842, 844 [defective heat

exchangers, a component of a natural gas plant].) Accordingly, the mere "presence" of asbestos was enough to trigger physical injury to tangible property as a prerequisite for coverage. *Id.*, 45 Cal.App.4th at 93-94. Coverage was "triggered" at the time the asbestos was installed, at the time it was released, at the time it was removed or any other relevant time. *Id.,* 45 Cal.App.4th 102. See also *Montrose Chemical Co. v. Admiral Insurance Co*. (1995) 10 Cal.4th 645, 661 and *Lac d'Amiente du Quebec v. American Home Assurance* (D.N.J. 1985) 613 F.Supp. 1549, 1561.

Significantly, and unlike *Aas*, *Armstrong* cited and relied upon *Eljer* – a plumbing case --with approval:

> "The Seventh Circuit Court of Appeals has held that in light of the purposes of insurance, **property damage occurs in the policy year in which a defective product is installed**, rather than the policy year in which it fails or is replaced in anticipation of failure or causes the market value of the building to diminish. "[T]he incorporation of a defective product into another product inflicts physical injury in the relevant sense on the latter at the moment of incorporation--here, the moment when the defective Qest [plumbing] systems were installed in homes." (*Eljer Mfg., Inc. v. Liberty Mut. Ins. Co*., *supra*, 972 F.2d at p. 814; see also *Colonial Gas Co. v. Aetna Cas. & Sur. Co*. (D.Mass. 1993) 823 F. Supp. 975 [installation of "UFFI" insulation].)

The *Armstrong* court was persuaded by the *Eljer* view and found it applicable to asbestos products. *Id*., 45 Cal.App.4th at 100.

INCORPORATION ADOPTED IN THE RECENT FEBRUARY 2000, *SHADE FOODS* CASE

In *Shade Foods, Inc. v. Innovative Products Sales and Marketing, Inc.* (2000) 78 Cal.App.4th 847, Shade developed a process for manufacturing nut clusters composed mainly of diced almonds and congealed syrup, together with small portions of walnuts and pecans. Shade began manufacturing this product for use in a General Mills breakfast cereal called "Clusters" in the 1980's. In 1993 and 1994, it sold about $ 12 million of the product to General Mills under a standard purchase order. *Id.*, 78 Cal.App.4th at 861.

Shade initially purchased processed almonds from various suppliers in California for the manufacture of the nut clusters. In 1992 and 1993, IPS, an almond processor in Madera, California, made a bid for this business by installing equipment in its plant for roasting and dicing almonds to the specifications required for the product. Shade ultimately entered into an agreement with IPS for the supply of processed almonds beginning in October 1993. *Id.*

In 1994, Shade was insured by a commercial general liability policy issued by Royal with limits of two million dollars per occurrence. IPS was insured by a package policy issued by Northbrook that provided general liability coverage with a one million dollar limit per occurrence and property coverage for "stock" with a three million dollar limit. The Northbrook liability insurance policy contained a vendor's endorsement that named Shade as an additional insured. *Id.,* 78 Cal.App.4th at 861-862.

On April 5, 1994, General Mills notified Shade that wood splinters had been found in the nut clusters used in its boxed cereals. Shade itself did not use wood in proximity to its product manufacturing facilities and suspected that the processed almonds supplied by IPS were the source of the splinters. Upon manually inspecting 80,000 pounds of diced almonds from IPS, Shade found 295 pieces of wood splinters, weighing about a quarter of a pound. Many of the pieces were potentially injurious to consumers, being sharply pointed and one-fourth inch to two or three inches long. Shade identified a possible source of the contamination in a "bin lifter" at the IPS plant which dumped loads of almonds on wooden pallets and into a hopper that fed a conveyor belt. *Id.,* 78 Cal.App.4th at 862.

General Mills shut down production of its Clusters cereal, shipped its supply of nut clusters back to Shade, and destroyed its entire stock of contaminated boxes of cereal. Shade was unable to find any use for the contaminated nut clusters, but it was able to mitigate its losses on its stock of diced almonds by grinding the almonds into powder and selling them as almond paste. General Mills presented Shade with a claim that was ultimately reduced to the precise figure of $ 1,347,932.20. About one million dollars of this sum represented the value of cereal it was compelled to destroy. *Id.*

The case was tried in 1996 and IPS was found liable for the wood splinters in the cereal. *Id.,* 78 Cal.App.4th at 863. On appeal, Northbrook's primary contention was that the damages claimed by IPS and Shade did not constitute "property damage" within the meaning of the insuring agreement. The insuring clause obligated the insurer to

> "pay those sums that the insured becomes legally obligated to pay as damages because of bodily injury or property damage to which this insurance applies."

The term "property damage" IS DEFINED IN RELEVANT PART AS FOLLOWS:

> "PROPERTY DAMAGE MEANS: [P] a. Physical injury to tangible property, including all resulting loss of use of that property." *Id.*, 78 Cal.App.4th at 865.

Northbrook relied on a line of cases holding that the diminution in the value of a product by reason of a defective part or faulty workmanship does not constitute property damage within the meaning of the standard insuring clause. (*Golden Eagle Ins. Co. v. Travelers Companies* (9th Cir. 1996) 103 F.3d 750 [faulty construction of apartment building]; *New Hampshire Ins. Co. v. Vieira* (9th Cir. 1991) 930 F.2d 696,

697-701 [faulty installation of drywall]; *Hamilton Die Cast, Inc. v. United States F. & G. Co.* (7th Cir. 1975) 508 F.2d 417, 419 [defective tennis racket frame]; *Seagate Technology v. St. Paul Fire and Marine Ins.* (N.D.Cal. 1998) 11 F. Supp.2d 1150, 1154-1155 [defective disk drive in computer]; *St. Paul Fire & Marine Ins. Co. v. Coss* (1978) 80 Cal. App. 3d 888, 892-893 [145 Cal. Rptr. 836] [defective materials used in construction of a house]; *Fresno Economy Import Used Cars, Inc. v. United States Fid. & Guar. Co.* (1977) 76 Cal. App. 3d 272, 284 [142 Cal. Rptr. 681] [defective head gasket in car].) *Id.*

The appellate court in *Shade*, however, distinguished these cases from the *Geddes* line of cases finding property damage when a defective part causes injury to other property. (*Geddes & Smith, Inc. v. St. Paul Mercury Indemnity Co.* (1959) 51 Cal. 2d 558, 565 [334 P.2d 881].) Thus, in *Eljer Mfg., Inc. v. Liberty Mut. Ins. Co.* (7th Cir. 1992) 972 F.2d 805, a defective plumbing system caused water leakage within a year or more after it was installed in houses and apartments. Finding property damages within the meaning of the standard-form definition at issue here, the court held that the term includes "loss that results from physical contact, physical linkage, as when a potentially dangerous product is incorporated into another and . . . must be removed, at some cost, in order to prevent the danger from materializing." (*Id.* at p. 810.) *Id.*

Shade made it clear that a defective component, when incorporated into other components, creates physical damage to a defective structure, and obligates a liability carrier to indemnify its insured for such a covered loss:

> "While the distinction may sometimes be a fine one to draw, we see no difficulty in finding property damage where a potentially injurious material in a product causes loss to other products with which it is incorporated. Our decision in *Armstrong World Industries, Inc. v. Aetna Casualty & Surety Co.* (1996) 45 Cal. App. 4th 1 [52 Cal. Rptr. 2d 690] is closely in point. There, the insured was sued repeatedly for the manufacture of asbestos-containing building material, such as floor tile and insulation. In general, the plaintiffs sought damages for the cost of removing the material or for the diminished value of the building resulting from its presence. Relying on *Eljer Mfg., Inc. v. Liberty Mut. Ins. Co., supra,* 972 F.2d 805, we noted that the presence of asbestos causes injury to a building "because the potentially hazardous material is physically touching and linked with the building . . . ." (*Armstrong World Industries, Inc. v. Aetna Casualty & Surety Co., supra*, at p. 92.) We concluded "that the alleged injury from installation of [asbestos-containing building material] qualifies as 'physical injury to . . . tangible property' " under the terms of the standard-form policy. (*Id.* at p. 94.)

The *Shade* court concluded that in following their decision in *Armstrong*, "we hold that the presence of wood splinters in the diced roasted almonds caused property damage to the nut clusters and cereal products in which the almonds were incorporated." *Id.*, 78 Cal.App.4th at 865-866 (emphasis added). Thus, in conclusion, the incorporation doctrine is alive and well in California and should be

used as an alternate method to establish property damage and physical injury required by *Aas*.