

Wisconsin Supreme Court Holds the Integrated Systems Rule No Longer Applies to Determine Coverage Under a CGL Policy

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Posted By: Jonathan J. Feldbruegge

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In its recent opinion in *5 Walworth, LLC v. Engerman Contracting, Inc.*, 2023 WI 51, the Wisconsin Supreme Court overruled its prior decision in *Wisconsin Pharmacal Co., LLC v. Nebraska Cultures of California, Inc.*, 2016 WI 14, 367 Wis. 2d 221, 876 N.W.2d 72. Specifically, the Court rejected its analysis in *Pharmacal* that in order for coverage to apply under the standard insuring agreement of a CGL policy, the alleged property damage must be to property other than the allegedly defective product or work. In place of *Pharmacal*, the Court reaffirmed its prior analysis in *American Girl*, i.e. an initial grant of coverage is made simply by demonstrating damage to property that was caused by an occurrence. While faulty workmanship is not an occurrence, it can lead to an occurrence causing covered property damage.

Previous Analysis Under *Pharmacal*

Pharmacal concerned coverage under a CGL policy for a seller of probiotics. The seller sold an incorrect bacteria, which was subsequently utilized as an ingredient in a dietary supplement. In analyzing the issues, the Wisconsin Supreme Court reiterated "[t]he risk intended to be insured [in a CGL policy] is the possibility that the goods, products or work of the insured, once relinquished or completed, will cause bodily injury or damage **to property other than to the product or completed work itself**, and for which the insured may be found liable." *Pharmacal*, 2016 WI at ¶ 24. (quoting case omitted). "A CGL policy's sole purpose is to cover the risk that the insured's goods, products, or work will cause bodily injury or property damage to property **other than the product or the completed work of the insured.**" *Id.* at ¶ 26. (quoting case omitted).

To determine whether a component part of a product damaged the rest of the product, or some **other product**, the Wisconsin Supreme Court employed the integrated system analysis. That is, whether the product "is to be treated as a unified whole or whether a defective component can be separated out such that the claimed damage constitute[d] damage to property other than the defective component itself." *Id.* at ¶ 28.

What constitutes harm to other property rather than harm to the product itself may be difficult to determine. A product that nondangerously fails to function due to a product defect has clearly caused harm only to itself. A product that fails to function and causes harm to surrounding property has clearly caused harm to other property. However, when a component part of a machine or a system destroys the rest of the machine or system, the characterization process becomes more difficult. When the product or system is deemed to be an integrated whole, courts treat such damage as harm to the product itself.

Id. at ¶ 27. Applying its analysis, the Wisconsin Supreme Court held "there [was] no 'property damage' caused by an 'occurrence' because the incorporation of [the] defective ingredient into the supplement did not damage **other property** and did not result in loss of use of property." *Id.* at ¶ 3.

New Approach Following 5 Walworth

In the recent opinion authored by Justice Hagedorn, the Wisconsin Supreme Court eviscerated *Pharmacal* and the "other property" requirement.

5 Walworth centered on an allegedly defective pool. In its written decision, the Court analyzed whether alleged defective construction (workmanship) and materials used in the construction of the swimming pool satisfied the insuring agreements of various CGL policies issued to the construction professionals. Ultimately, the Court rejected its prior analysis in *Pharmacal* and the use of the integrated systems analysis to make insurance coverage determinations. The Court stated that *Pharmacal* was a departure from its prior decisions.

A threshold question in this case concerns how to analyze whether there has been "property damage" caused by an "occurrence" under the three CGL policies. The argument centers around our decision in *Wisconsin Pharmacal Co., LLC*...where we stated that "property damage" under a CGL policy requires damage to "other property" and utilized the "integrated systems analysis"... At a basic level, the integrated systems analysis asks whether the product is part of an integrated whole such that any damage can be ascribed only to the product itself, rather than to other property. ...

...With the benefit of hindsight, we conclude our approach in *Pharmacal* was a departure from our well-established law...*Pharmacal* wrongly stated that "property damage" must be to "other property" for purposes of determining an initial grant of coverage in a CGL policy. It then improperly imported the integrated systems analysis to determine if "other property" was damaged.

5 Walworth, 2023 WI 51 at ¶¶ 2-3. In rejecting *Pharmacal*, the Wisconsin Supreme Court reaffirmed its analysis in *American Girl*, specifically that while faulty workmanship is still not necessarily an occurrence, it can cause an occurrence leading to property damage that is covered under the CGL policy.

The lesson from our case law examining similar policy language is this: faulty workmanship is not an occurrence, but faulty workmanship can lead to an occurrence that causes property damage.

Turning to the summary judgment record, the [expert reports] concluded that cracks in the main pool occurred, and therefore water leaked into the surrounding soil. This was the result, according to the report, of less-than-optimal installation of the [concrete] and poor placement of steel reinforcing bars, among other reasons. The improper installation of the [concrete] and the incorrect placement of the steel reinforcing bars are not enough on their own to constitute an occurrence; if proven, that is faulty workmanship. But the record can support a conclusion that this faulty work caused the pool to crack and leak, and those cracks became worse as the pool leaked and destabilized the surrounding soil. The cracks, leakage, and soil damage could constitute accidents—unexpected and unforeseen events—caused by improper installation. And these cracks and the damage to the surrounding soil also could constitute physical injuries to the homeowner's tangible property...

Id. at ¶¶ 35-36. The Court has remanded the case back to the Circuit Court for further proceedings.

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