COURT OF APPEALS
DECISION
DATED AND FILED

April 16, 2013

Diane M. Fremgen
Clerk of Court of Appeals

Appeal No. 2012AP1260 **Cir. Ct. No. 2008CV1153**

STATE OF WISCONSIN **IN COURT OF APPEALS**
DISTRICT III

KONRAD MARINE, INC.,

PLAINTIFF,

V.

MARINE ASSOCIATES, INC.,

DEFENDANT-RESPONDENT,

REGENT INSURANCE COMPANY,

DEFENDANT-APPELLANT.

APPEAL from a judgment of the circuit court for St. Croix County: SCOTT R. NEEDHAM, Judge. *Affirmed in part; reversed in part and cause remanded with directions.*

Before Hoover, P.J., Mangerson, J., and Thomas Cane, Reserve Judge.

¶1 HOOVER, P.J. Regent Insurance Company appeals a judgment incorporating a declaration that Regent is obligated to indemnify its insured, Marine Associates, Inc. Marine Associates was found liable for improperly cutting teeth into gears, which were then incorporated into another product. Regent argues there was no coverage under Marine Associates' commercial general liability (CGL) policy, primarily because the business-risk exclusions apply. We hold that some, but not all, of the damages awarded by the jury were covered losses. We therefore remand for the circuit court to conduct any proceedings necessary to determine the amount of covered damages.

BACKGROUND

¶2 Konrad Marine, Inc., manufactures stern drives for boats with inboard engines. A stern drive transfers power from the engine to the propeller through a series of gears, and is also used to steer the boat. Konrad hired Marine Associates to cut teeth into sets of gear and pinion blanks that Konrad supplied. Konrad and two additional companies did further work on the gears before Konrad installed them in its stern drives.

¶3 Konrad's stern drives, which were installed on high performance boats, suffered numerous failures. Upon inspection of the damaged stern drives, Konrad discovered that the gears cut by Marine Associates were missing teeth. Konrad employees explained that there were catastrophic gear failures which compromised the entire stern drive unit. Teeth were shed off the gears and metal pieces traveled throughout the stern drive unit causing damage to bearings, other gear sets, seals, and stern drive housings. The stern drives failed shortly after being put to use, with some failures occurring at "poker run" boat racing events. The news of the failures resulted in a loss of customers and decreased sales.

Konrad contacted its customers and replaced any defective gear sets that had not yet failed.

¶4 Konrad determined that the gear failures arose from defective teeth-cutting by Marine Associates. Konrad successfully sued Marine Associates, although the jury found the parties each fifty percent negligent.[1] The jury awarded three categories of damages in a special verdict, as follows: (a) cost of warranty repair/recall: $167,000; (b) labor/testing costs: $41,000; (c) lost profits: $367,000. Given the shared negligence determination, Marine Associates was adjudged liable for fifty percent of the damages. After trial, the court denied Regent's pending motion to declare that it had no duty to indemnify Marine Associates. Regent now appeals.

DISCUSSION

¶5 Regent does not dispute that the policy provides coverage for any property damage to stern drives, i.e., other property, resulting from failed gears. However, Regent contends there is no coverage for the costs of installed gear sets that failed, replacement gears, or testing to determine the cause of failures, because the "your work" or "your product" business-risk exclusions apply. In a related argument, Regent asserts that any defective gear sets that were not installed in stern drives did not cause "property damage" under the policy definition. Regent further argues that, with respect to any costs incurred to replace gear sets in Konrad's customers' stern drives that had not yet failed, (1) there is no initial grant of coverage because there was no "property damage," (2) the business-risk

[1] In the underlying case on the merits, Marine Associates unsuccessfully argued to the circuit court that the economic loss doctrine applied. That ruling is not challenged on appeal.

exclusions apply, and (3) the "recall" exclusion applies. Finally, Regent argues there is no coverage for Konrad's claim for lost profits. Marine Associates counters with an alternative coverage theory and an argument that the policy provided illusory coverage.

¶6 Interpretation of an insurance contract presents a question of law subject to our independent review. ***American Family Mut. Ins. Co. v. American Girl, Inc.***, 2004 WI 2, ¶23, 268 Wis. 2d 16, 673 N.W.2d 65. When interpreting an insurance policy, we seek to determine and give effect to the intent of the contracting parties. ***Id.*** Additionally, policies are to be construed as they would be understood by a reasonable person in the position of the insured. ***Id.*** Coverage questions may involve three inquiries: whether there is an initial grant of coverage; whether an exclusion applies; and whether an exception applies to an exclusion and reinstates coverage. ***Id.***, ¶24.

¶7 Marine Associates' policy provides that Regent "will pay those sums that the insured becomes legally obligated to pay as damages because of … 'property damage' to which this insurance applies."[2] The policy recognizes two types of "property damage," defining it as:

> a. Physical injury to tangible property, including all resulting loss of use of that property. All such loss of use shall be deemed to occur at the time of the physical injury that caused it; or
>
> b. Loss of use of tangible property that is not physically injured. All such loss of use shall be deemed to occur at the time of the "occurrence" that caused it.

[2] The CGL policy is a standard form bearing an Insurance Services Office (ISO) date of 2003. *See* ***Wisconsin Label Corp. v. Northbrook Prop. & Cas. Ins. Co.***, 2000 WI 26, ¶27 n.3, 233 Wis. 2d 314, 607 N.W.2d 276 (most CGL insurance in the United States is written on standardized forms promulgated by ISO).

However, the policy only covers property damage that "is caused by an 'occurrence' …." As relevant here, occurrence is defined as "an accident."

"Your property" and "your work" exclusions

¶8 Regent argues the "your property" and "your work" business-risk exclusions bar coverage for any damages relating to faulty gears, whether installed in stern drives or not, and including the cost of replacing gears or testing to determine the cause of failure. As relevant, these exclusions bar coverage for "property damage" to "your product" or "your work" "arising out of it or any part of it." "Your product" means "[a]ny goods or products … manufactured, sold, handled, distributed or disposed of by" the insured. "Your work" means "[w]ork or operations performed by [the insured] or on [its] behalf." Both definitions also include "materials, parts or equipment furnished in connection with" the product or work.

¶9 Marine Associates agrees that the exclusions apply here, regardless whether the faulty gears are viewed as its product or as its work. However, it first contends that Konrad did not seek, and the jury therefore did not award, any damages with respect to the faulty gears themselves. We disagree.

¶10 Marine Associates' argument focuses on a table identified as exhibit 525, as well as testimony about that exhibit. That table includes Konrad's claimed costs incurred for both "Assembled Defective Gear Sets" and "Unused Defective Gear Sets." It also includes costs incurred for both "Gear Change[s]" and "New Upper Gear Sets." Further, contrary to Marine Associates' assertion, the testimony it relies on merely indicates that costs related to the gears were not double-counted within other line items on the table. We therefore reject Marine Associates' argument and agree with Regent that the "your property" and/or "your

work" exclusions apply and bar coverage of damages that Konrad sought at trial. "CGL policies do not provide coverage for the insured's liability for repairing or replacing the insured's defective work[.]" ***Wisconsin Label Corp. v. Northbrook Prop. & Cas. Ins. Co.***, 2000 WI 26, ¶33, 233 Wis. 2d 314, 607 N.W.2d 276. Additionally, Marine Associates does not dispute that Konrad was awarded damages for costs of testing to determine the cause of failure. Thus, Marine Associates is deemed to have conceded that issue. *See* ***Charolais Breeding Ranches, Ltd. v. FPC Secs. Corp.***, 90 Wis. 2d 97, 109, 279 N.W.2d 493 (Ct. App. 1979).

¶11 Because we have determined the unused gear sets were excluded from coverage by the business-risk exclusions, we need not reach Regent's alternative argument that those gears did not cause property damage in the first instance. *See* ***State v. Castillo***, 213 Wis. 2d 488, 492, 570 N.W.2d 44 (1997) (appellate courts not required to address every issue raised when one issue is dispositive).

¶12 Regent separately addresses the "costs associated with recalling stern drives from some customers where the stern drives had not yet failed." It argues there is no coverage for these costs because (1) there is no initial grant of coverage because there was no "property damage," (2) the business-risk exclusions apply, and (3) the "recall" exclusion applies. We have already determined that the "your work" and/or "your product" exclusions apply to costs associated with repairing or replacing defective gears. Therefore, we need not resolve whether the costs resulted from "property damage" or whether the "recall" exclusion also applies. *See* ***id.*** However, Marine Associates concedes that, unless it prevails on its incorporation-of-defective-product argument discussed below, the

recall exclusion would bar coverage for costs incurred relative to those stern drives in which the gear sets had not yet failed.

Diminution-in-value/incorporation-of-defective-product coverage theory

¶13 Marine Associates responds with an alternative coverage theory, which would purportedly provide coverage for all damages, except for costs related to defective gears that were never utilized. Marine Associates argues there was "property damage" to the stern drives (i.e., property other than its own work or product) at the very moment Konrad incorporated the faulty gears into the drives, regardless whether there was subsequent physical injury or loss of use. Marine Associates' incorporation theory relies on ***Eljer Manufacturing v. Liberty Mutual Insurance Co.***, 972 F.2d 805 (7th Cir. 1992).

¶14 We reject Marine Associates' argument that "property damage" occurred upon incorporation of the faulty gears into the stern drives. Wisconsin does not accept the diminution-in-value/incorporation theory of property damage recognized in ***Eljer***. In ***Eljer***, 972 F.2d at 813-14, the federal court was applying Illinois law. Citing ***Wisconsin Label***, 233 Wis. 2d 314, Marine Associates argues we should follow ***Eljer*** because "Illinois and Wisconsin [courts] are not in conflict with respect to their interpretation of the provisions in a CGL policy relevant to this case." This is a peculiar argument. After the federal ***Eljer*** decision, the same manufacturer in that case found itself before the Illinois Supreme Court, which thoroughly rejected the federal court's analysis. *See* ***Travelers Ins. Co. v. Eljer Mfg.***, 757 N.E.2d 481 (Ill. 2001). The Illinois court held, "We believe that the ***Eljer*** majority erred when it set aside the 'central,' plain, and ordinary meaning of the term 'physical injury,' and instead employed an admittedly 'conjectured'

analysis with respect to the function that the phrase was intended to perform in a CGL policy." ***Id.*** at 497.

¶15 Marine Associates' argument is especially peculiar because, while ***Wisconsin Label*** does cite ***Eljer***, it *rejects* ***Eljer***'s rationale.[3] ***Eljer*** determined that when ISO revised the standard CGL policy in 1973 by adding the qualifier "physical" to the term "injury" in the property damage definition, no change in meaning was intended. ***Eljer***, 972 F.2d at 810-12. Our supreme court disagreed. It held, "Unlike the 1966 definition, neither part of the later definition is broad enough to encompass mere 'diminution of value' of a product in the absence of physical injury or loss of use." ***Wisconsin Label***, 233 Wis. 2d 314, ¶47. Thus, it rejected both ***Eljer*** and ***Sola Basic Industry, Inc. v. United States Fidelity & Guaranty Co.***, 90 Wis. 2d 641, 654, 280 N.W.2d 211 (1979), where the court had found that diminution in value constituted property damage under the pre-1973 definition. ***Wisconsin Label***, 233 Wis. 2d 314, ¶¶46-48. Further, the court stated it agreed with the Illinois appellate court's holding that "***Eljer*** ignored the plain meaning of the phrase 'physical injury' when it interpreted the policy to provide coverage for the intangible diminution in value that resulted from installation of leaky pipes."[4] ***Id.***, ¶¶47-48 (citing ***Travelers Ins. Co. v. Eljer Mfg.***, 718 N.E.2d

[3] ***Wisconsin Label*** was decided after the Illinois Court of Appeals had rejected ***Eljer Manufacturing v. Liberty Mutual Insurance Co.***, 972 F.2d 805 (7th Cir. 1992), but before the Illinois Supreme Court had done so. *See* ***Wisconsin Label***, 233 Wis. 2d 314, ¶37.

[4] In ***Eljer***, the majority observed that language was an imperfect medium and that, "In effect we are being asked to choose between '*physical* injury' and 'physical *injury*.'" ***Eljer Mfg. v. Liberty Mut. Ins. Co.***, 972 F.2d 805, 810 (7th Cir. 1992). The court eschewed "literal" "ordinary-language" "commonsensical, lay person's" interpretation, and instead based its analysis on the objectives of insurance and assumptions and inferences concerning drafting history by ISO. ***Id.*** at 808-12, 814. In Wisconsin, however, courts start with the contract's language when determining the parties' intent. *See* ***Wisconsin Label***, 233 Wis. 2d 314, ¶¶23-25.

1032, 1040-41 (Ill. App. Ct. 1999), *aff'd* 757 N.E.2d 481); *see also* ***Tweet/Garot-August Winter LLC v. Liberty Mut. Fire Ins. Co.***, No. 06-C-800, 2007 WL 445988, at *4-7 (E.D. Wis. Feb. 7, 2007) (rejecting ***Eljer*** under Wisconsin law).

¶16 We further observe that Marine Associates' incorporation argument fails to account for the policy's "occurrence" requirement. Marine Associates itself asserts:

> Faulty workmanship is not an occurrence itself but may cause an occurrence. Faulty workmanship may cause an unintended event (the fracturing of the gears) and that event, the occurrence, can result in damage to other property. [***American Girl***, 268 Wis. 2d 16, ¶40]; ***Glendenning's Limestone and Ready-Mix Co. v. Reimer***, [2006 WI App 161,] 295 Wis. 2d 556, 721 N.W.2d 704 ….
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> ....
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> The failing of the gears with the infliction of damage throughout the stern drives was an occurrence which caused property damage.

Marine Associates does not proffer any alternative occurrence. The policy states that it only covers property damage that is caused by an occurrence, i.e., an accident. Of course, property damage—here the diminution of value due to incorporation of faulty gears—cannot logically precede its cause. Thus, the subsequent gear failure (if any) cannot constitute the occurrence. If the faulty workmanship is not the occurrence, it would appear that the only other event that could be an occurrence would be Konrad's incorporation of the faulty gears. That, however, was no accident. Konrad intentionally installed the gears as a necessary component of its stern drive system.

Consequential damages—lost profits

¶17 We next address Regent's argument that the policy did not afford coverage for Konrad's lost profits. Regent asserts that lost profits "are an economic claim and not a claim for physical injury to tangible property." It further contends the lost profits "are consequential economic loss derived from the economic loss of the defective gears themselves, and accordingly are not covered." Neither of these first two assertions is supported by an adequately developed legal argument. We therefore need not address them. *See* ***State v. Flynn***, 190 Wis. 2d 31, 39 n.2, 527 N.W.2d 343 (Ct. App. 1994). Nonetheless, we observe that a standard CGL policy does not categorically preclude coverage for all "economic" losses. *See* ***American Girl***, 268 Wis. 2d 16, ¶¶39-47; ***Wisconsin Label***, 233 Wis. 2d 314, ¶¶53, 56 (lost profits may be covered consequential damages under CGL policy) (citing ***Western Cas. & Surety Co. v. Budrus***, 112 Wis. 2d 348, 332 N.W.2d 837 (Ct. App. 1983)).

¶18 Regent next argues that, in any event, the lost profits did not result from a covered loss because they arose solely from the failure of the defective gears. This argument relies entirely on a nonprecedential case, ***Wausau Underwriters Ins. Co. v. United Plastics Group, Inc.***, 512 F.3d 953 (7th Cir. 2008), which we are free to disregard.

¶19 In ***Wisconsin Label***, 233 Wis. 2d 314, ¶57, the court explained that "economic losses will be covered under a CGL policy only when the policy language creates coverage for such losses." Like there, coverage applies here only when damages are "because of" "physical injury to tangible property" or "loss of use of tangible property." *See* ***id.*** Regent argues the lost profits arose from the gear failures (noncovered loss), not from the physically damaged stern

drives (covered loss). It reasons that, from the perspective of customers, all that mattered was that the stern drives did not work, and that they did not work because the damaged gears could not transfer power to the propeller.

¶20 We disagree. It is not practicable under the facts of this case to parse the source of consequential lost profits between both noncovered and covered losses. Here, there was physical injury to some or all of the stern drives when the teeth sheared off the gears. One can reasonably infer that that additional harm, above and beyond gear failure, contributed to customers' perceptions regarding the stern drives.

¶21 Regardless, the policy's "property damage" definition includes "[p]hysical injury to tangible property, including all resulting loss of use of that property[,]" as well as "[l]oss of use of tangible property that is not physically injured." Thus, Konrad's customers' "loss of use" of stern drives was a covered loss. Customers purchased a single, integrated product. When those products failed, leading to a complete loss of use, Konrad lost potential customers. Accordingly, Marine Associates' liability for the lost-profits damages was "because of" "property damage." We therefore reject Regent's argument that the lost profits did not arise from a covered loss.

Illusory coverage

¶22 Finally, Marine Associates argues the policy provides illusory products-completed operations coverage. It contends it receives no actual coverage for this risk despite it being separately identified on the declarations page with a separate liability limit. It further asserts that the products-completed operations hazard *definition* provides an independent grant of coverage that is not subject to the business-risk exclusions.

¶23 As Marine Associates acknowledges, we recently rejected the same arguments in ***Pamperin Rentals II, LLC v. R.G. Hendricks & Sons Constr.***, 2012 WI App 125, 344 Wis. 2d 669, 825 N.W.2d 297. Contrary to Marine Associates' claim, in that case we explained in detail why there was no illusory coverage or ambiguity. Marine Associates' argument is without merit.

Summary

¶24 The circuit court did not resolve Regent's pending coverage motion until after trial. The jury verdict allocated damages as follows: (a) cost of warranty repair/recall: $167,000; (b) labor/testing costs: $41,000; (c) lost profits: $367,000. We have determined that the para. (b) damages for labor/testing costs were excluded from coverage by the business risk exclusions, but that the para. (c) lost profits were covered. We cannot, however, determine what amount of damages awarded for para. (a) warranty repair/recall are covered losses.

¶25 Any para. (a) warranty damages attributed to the repair or replacement of faulty gears sets are not covered, whereas any damages attributed to stern drives are covered. Regent asserts that the parties stipulated 35% of the warranty costs were related to the gears and 65% were related to the stern drives. Marine Associates disputes that there was an actual agreement or stipulation. The record does not clearly indicate that a stipulation was reached.[5] Further, Konrad's

[5] Counsel for Marine Associates improperly attempts to enlarge the record with his own recollection of the matter. *See* WIS. STAT. RULE 809.19(1)(d), (3)(a)2. We disregard that gratuitous information. Further, we admonish counsel that future violations may result in sanctions. *See* WIS. STAT. RULE 809.83(2).

All references to the Wisconsin Statutes are to the 2011-12 version unless otherwise noted.

exhibit setting forth its various losses identified damages far exceeding that awarded by the jury. Thus, we are unable to independently determine the allowable amount of warranty damages. On remand, the circuit court may conduct whatever proceedings it deems necessary to resolve this factual question.

¶26 No WIS. STAT. RULE 809.25 costs allowed.

By the Court.—Judgment affirmed in part; reversed in part and cause remanded with directions.

Not recommended for publication in the official reports.