2016 WL 7048251 (C.A.7) (Appellate Brief)
United States Court of Appeals, Seventh Circuit.

Mary HALEY, On Behalf of Herself and All Others Similarly Situated, et al., Plaintiffs,
v.
KOLBE & KOLBE MILLWORK CO., INC., Defendant-Appellant, Cross Appellee,
and
FIREMAN'S FUND INSURANCE COMPANY, Intervenor-Appellee, Cross-Appellant.

Nos.
16
-
3563
, 16-3648.
November 28, 2016.

Appeal from the United States District Court For the Western District of Wisconsin
Case No. 3:14-cv-00099-BB
Honorable Barbara B. Crabb, Presiding

Amicus Curiae Brief of United Policyholders' in Support of Defendant-Appellant, Cross Appellee Kolbe & Kolbe Millwork Co., Inc.'s Brief Seeking Reversal of District Court's Ruling

Gregory L. Dillion, SBN 93715, Alan H. Packer, SBN 124724, Graham C. Mills, SBN 233261, Jacquelyn M. Mohr, SBN 278337, Newmeyer & Dillion, LLP, 1333 N California Blvd., Suite 600, Walnut Creek, CA 94596, for Amicus Curiae, United Policyholders.

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*1 I. *INTRODUCTION*

The District Court's opinion, if not reversed, will deprive policyholders and consumers of coverage to remedy construction related property damage and effectively leave contractors, manufacturers, and material suppliers with no way to protect themselves from the most likely liabilities arising out of their work. [1] This case centers on the interpretation of a standard form insurance policy and the outcome will impact the entire construction industry in Wisconsin, with repercussions for the housing, landlord, and business property owner sectors of the economy. Each year contractors, subcontractors, manufacturers, and material suppliers pay very substantial insurance premiums for peace of mind and the security of knowing that if their work, or their products, are involved in a property damage claim, they have protection from potentially ruinous losses. Each year business and home owners pay millions of dollars for construction work with the understanding that the work is insured. These consumers of construction services reasonably believe the commercial general liability ("CGL") policies that reputable vendors maintain will compensate them in the event their property is damaged or destroyed in the course of that work. Wisconsin insurers cannot be permitted to collect premiums for providing coverage for property damage, then turn around and creatively argue their way out of supporting their policyholders and depriving consumers of remedies. The stakes for Wisconsin's residents and economy are simply too high to allow that to happen.

United Policyholders ("UP") respectively submits this brief in support of the position of Defendant-Appellant, Cross Appellee Kolbe & Kolbe Millwork Co., Inc. ("Kolbe"). UP strongly supports Kolbe's view that the District Court's extravagant excursion well beyond established Wisconsin insurance law was reversible error. The insurance policies at issue in the underlying case (as well as those at issue for contractors, manufacturers, material suppliers, and ***2** consumers throughout the state) clearly provide coverage for property damage other than damage to the work of the insured itself.

UP's *amicus curiae* brief seeks to assist this Court in evaluating the equities and reviewing applicable precedents as well as the impacts beyond the interests of the litigants before this Court. The core issue addressed by UP is whether an insurer that sells an insurance policy to contractors and vendors whose only at-risk operations are to perform work, or provide materials, on structures may refuse to provide coverage when that work or those materials causes damage to the structures on which their work or materials were incorporated. Put another way, when an insurer knows precisely the

business its policyholders are engaged in (manufacturing and installing windows), sells them an insurance policy to cover the most obvious risks of the business (that the windows are defective and cause damage to the homes in which they are installed) and collects large premiums for years, may the insurer then be allowed to escape its obligation to provide the bargained for protection by arguing semantics when the policyholder seeks coverage? The answer to that inquiry has to be a resounding no. If the ruling of the District Court stands, it will seriously erode the protections on which contractors, subcontractors, manufacturers, and material suppliers as well as businesses and residential consumers have relied upon for decades, eliminate liability coverage for the most typical losses arising out of construction activities, and eliminate remedies for business and residential consumers whose homes or properties are damaged or destroyed.

III. *SUMMARY OF ARGUMENT*

The District Court's ruling is counter to established Wisconsin law, the terms of the insurance policies, the reasonable expectations of policyholders, and the interests of consumers. Participants in the construction industry (from developers to general contractors to subcontractors and extending to manufacturers, and material suppliers such as Kolbe) face unique risks attendant to their participation in the process of construction. Those risks primarily revolve around the potential that their work or product may cause damage to the structures on which they are performed or installed. While these risks are unique, they are well known to the insurance industry.

The companies involved in the construction industry range from Fortune 500 companies to small, family owned businesses struggling to maintain their own payrolls. The consumers they service range from homeowners to the operators of large scale power plants and government buildings. In the event that property damage arises after operations are completed, many of them have very limited resources and the mere costs of litigating a lawsuit could spell the difference between remaining in business and shuttering their doors and putting their employees out of work. To address the risks of causing damage to the work of others, these businesses purchase insurance coverage that provide them coverage for "property damage" to property other than their own "product." That is precisely the nature of construction litigation - the primary risk that contractors, manufacturers, and suppliers face - and precisely why they spend thousands ***5** (hundreds of thousands of dollars, in Kolbe's case) of dollars on liability insurance: To protect themselves from lawsuits alleging that their work, or their product, caused damage in the home or structure in which they are performed or installed. Rightfully so, these policyholders do not expect that they will then be adverse to their insurance companies, precisely at the time they need them most.

For years, insurers have paid property damage claims similar to the ones being asserted against Kolbe because everyone - insurers and policyholders - understood that those claims were ones for "property damage" within the meaning of the CGL policy. In fact, the insurance industry specifically re-wrote key insurance forms in 1986 to remove any uncertainty about whether construction defect claims are "property damage". This expansion of coverage now forms the basic understanding between insurers and policyholders as to what is covered.

Unfortunately, the District Court's ruling calls into question that basic "meeting of the minds" between an insurer and its policyholder and so disregards the revisions made by the insurance industry itself to expand coverage for construction defect claims. The ruling strips away insurance coverage that everyone thought existed when the policyholder paid money to the insurer and the insurance policy was issued. Courts should not be in the business of nullifying insurance contracts, nor should insurance companies or judges play the role of underwriter by hindsight. [2] In its wake, the ruling will have two notable harmful consequences: (1) policyholders will have less protection than what the insurers had affirmatively promised to them when they purchased those insurance policies and (2) consumers will unable to secure sufficient funds needed to remedy construction defects.

***6** Alternatively, this court must reverse because the decision of the District Court improperly expands Wisconsin law. A federal court sitting in diversity should not be make new Wisconsin law; controlling Seventh Circuit jurisprudence

holds that only a Wisconsin court can do that. *Affiliated FM Ins. Co. v. Trane Co.*, 831 F.2d 153, 155 (7th Cir. 1987); *A. W. Huss v. Continental Cas. Co.*, 735 F.2d 246, 253 (7th Cir. 1984). Wisconsin has a strong public policy developed over many years of legislatively deciding that *more,* not less, insurance coverage should be available to both policyholders and consumers. The District Court's ruling is counter to that public policy and existing Wisconsin law and so should be reversed.

APPEARANCE & CIRCUIT RULE 26.1 DISCLOSURE STATEMENT

Appellate Court No: ***16-3563*** *and 16-3648*

Short Caption: *Mary Haley, et al. v. Kobe & Kobe Millwork Co., Inc., et al.*

To enable the judges to determine whether recusal is necessary or appropriate, an attorney for a non-governmental party or amicus curiae, or a private attorney representing a government party, must furnish a disclosure statement providing the following information in compliance with Circuit Rule 26.1 and Fed. R. App. P. 26.1.

The Court prefers that the disclosure statement be filed immediately following docketing; but, the disclosure statement must be filed within 21 days of docketing or upon the filing of a motion, response, petition, or answer in this court, whichever occurs first. Attorneys are required to file an amended statement to reflect any material changes in the required information. The text of the statement must also be included in front of the table of contents of the party's main brief. **Counsel is required to complete the entire statement and to use N/A for any information that is not applicable if this form is used.**
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United Policyholders

(2) The names of all law firms whose partners or associates have appeared for the party in the case (including proceedings in the district court or before an administrative agency) or are expected to appear for the party in this court:

Newmeyer & Dillion LLP

(3) If the party or amicus is a corporation:

i) Identify all its parent corporations, if any; and

N/A

ii) list any publicly held company that owns 10% or more of the party's or amicus' stock:

N/A

Attorney's Signature: ***S/ Gregory L Pillion*** Date: ***November 15, 2016***

Attorney's Printed Name: ***Gregory L. Pillion***

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N/A

Attorney's Signature: ***S/Alan H. Packer*** Date: *November 15, 2016*

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II. *STATEMENT OF INTEREST*

UP is a unique national non-profit 501(c)(3) organization that is dedicated to promoting and preserving integrity in insurance transactions, perhaps most importantly protecting the reasonable expectations of insurance consumers that they will get what they paid for. UP was ***3** founded in 1991 to be a voice and information resource for insurance consumers following a large firestorm that swept through the San Francisco Bay Area. The organization is funded by donations from individuals and businesses and grants from community foundations and governments. UP does not sell insurance or accept financial support from insurance companies.

Through its *Roadmap to Preparedness* program, UP guides consumers on buying insurance and being economically prepared for adverse events. UP's *Roadmap to Recovery* program helps individuals and businesses navigate the insurance claims process and recover fair and timely settlements. Finally, UP's *Advocacy and Action* program works with public officials, other non-profits, faith-based organizations, and a diverse range of entities - including insurance producers and insurance trade associations - to solve problems related to claims and coverage.

Since UP was founded in 1991, the organization has provided direct access to consumers across the country they have suffered damage to and destruction of their homes and businesses. UP has a particular interest in this case because of genuine concerns over the harm the District Court's ruling could bring to Wisconsin residents and the state's long term economic prospects. UP strives to aid courts, including the Seventh Circuit Court of Appeals *see, e.g., Advance Cable Company LLC v. Cincinnati Insurance Company*, 788 F.3d 743 (Nos. 14-2620 & 14-2748, decided June 11, 2015) via the submission of *amicus curiae* briefs in cases involving insurance principles that are likely to impact large segments of the general public and business communities. One of UP's *amicus curiae* briefs was cited in the U.S. Supreme Court opinion *Humana v. Forsyth*, 525 U.S. 299, 119 S.Ct. 710, 142 L.Ed.2d 753 (1999) and its arguments have adopted by numerous state and federal courts across the country.

UP seeks to fulfill the "classic role *of amicus curiae* in a case of general public interest, supplementing the efforts of counsel, and drawing the court's attention to law that escaped ***4** consideration." *Miller Wohl Co. v. Commissioner of Labor & Indus.*, 694 F.2d 203, 204 (9th Cir. 1982). An *amicus curiae* is often in a superior position to "focus the court's

attention on the broad implications of various possible rulings." Robert L. Stem, et al, *Supreme Court Practice* 570-71 (1986) (quoting Ennis, *Effective Amicus Briefs,* 33 Cath.U.L.Rev. 603, 608 (1984)).

IV. *LEGAL ARGUMENT*

A. The District Court's Ruling is Counter to the Rationale Underlying *Wisconsin Pharmacal*. In doing so, the District Court Overlooked the Fact That Windows Can Be Removed and Replaced.

The District Court's ruling is based nearly entirely upon the recent case of *Wisconsin Pharmacal Co.. LLC v. Nebraska Cultures of California. Inc.*, 2016 WI 14, 367 Wis.2d 221, 876 N.W.2d 72 (2016), a case ***not*** involving construction losses. The Wisconsin Supreme Court was addressing a very different type of loss then the one considered by the District Court. *Wisconsin Pharmacal* should ***not*** be extended where it is clearly at odds with common sense and logic.

In *Wisconsin Pharmacal*, the Wisconsin Supreme Court dealt with a situation where a manufactured probiotic tablet contained the wrong ingredient, and the issue before it was whether that constituted property damage. It concluded that the tablet constituted an "integrated" product, and that the mere inclusion of an improper component did not constitute "property damage" for purposes of a liability policy.

The District Court took that conclusion and ran with it, far beyond the confines of the decision itself. The District Court analogized the tablet - which was such an "integrated" ***7** product that the wrong ingredients *could not possibly be removed from the tablet* - to a home in which replacement windows are installed. Even though the windows caused actual physical harm to the homes in which they were installed, even though they thus constituted far more than merely a "wrong ingredient" in the homes, and even though the windows themselves were susceptible to replacement themselves, the District Court found that the damaged homes were just like the probiotic tablets, because they both "contain" something improper. It concluded that when a window is inserted then the entire house was an integrated system, even though the windows can be ***removed*** and ***replaced.*** Based on this conclusion, the District Court held that the damage caused to the house by the windows is merely damage within the integrated system, not to "other property." While the merits of the holding of *Wisconsin Pharmacal* are not currently before this Court, there are critical distinguishing facts between this action and *Wisconsin Pharmacal* that require reversal of the District Court.

In *Wisconsin Pharmacal*, the Wisconsin Supreme Court concluded that there was no "property damage" for a supplemental tablet composed of separate compounds. *Id.* At 2016 WI ¶ 3, 367 Wis.2d at 231, 876 N.W.2d at 75-76. This conclusion was based upon a single fact that is absent in this action: upon the mixing of those separate chemicals, a ***new*** product was formed. It was this new product - complete and whole unto itself - that constituted the policyholder's work for purposes of the relevant insurance policy. Critically, the Wisconsin Supreme Court focused on how the chemicals, once joined together, became something new - became, in fact, so "integrated" that one could not then remove one part of the tablet from the remainder.

That fact ***is absent*** here. Some of the windows at issue in this action are ***replacement*** windows. Either as new or as replacements, the windows were still windows and the house was still a house. This physical separation between a window and the house is obvious from just ***8** looking at the house. Unlike *Wisconsin Pharmacal* it is possible to see where the window ends and the house begins. And, unlike *Wisconsin Pharmacar*s tablet, it remains feasible to ***remove*** and ***replace*** a window from a house.

In fact, some of the windows were removed and replaced. There is no dispute about that. By definition, a replacement window meant that the original window was removed from the house and then another window inserted. This fact that one item was removed and another inserted makes the situation faced by the *Wisconsin Pharmacal* completely different, as it dealt only with the original integrated product sold as a whole undivisible object. Unlike *Wisconsin Pharmacal*, the mere fact that the windows can be removed means that there was ***never*** an integrated product. If the home was an

integrated product, then the replacement of the window would have necessarily meant that the entire home would need to have been destroyed and rebuilt. This is preposterous.

This conclusion flows from the language of *Wisconsin Pharmacal* itself. Once "wrong" probiotic had been joined to and incorporated with the rest of the tablets, *Wisconsin Pharmacal*, implicitly held that the boundary between the "your work" exclusion and coverage granted for "property damage" disappeared because the separate ingredients of the tablet had become a new single indivisible product, the component parts of which could no longer be effectively separated. However, for the windows at issue in this action, that boundary ***never*** disappeared. In fact, the boundary is physically shown when a window is removed and replaced; there is a hole in the house where the window used to be. Unlike in *Wisconsin Pharmacal*, that physical hole represents a clear separation between "your work" and "property damage".

Similarly, this case has all of the facts/allegations that were missing in ***9** *Wisconsin Label Corp. v. Northbrook Property & Cas. Ins. Co.*, 2000 WI 276, 233 Wis.2d 314, 607 N.W.2d 276 (2000). *Wisconsin Label Corp.* involved an insurance coverage dispute regarding coverage for products that had been marked with the wrong price. The *Wisconsin Label Corp.* court held that there was no "property damage" because the property itself was fine, it had just been marked with a wrong price sticker. *Id.* At 2000 WI ¶¶ 31-32, 23 Wis.2d at 331-32, 607 N.W.2d at 285. Those facts are absent here. And, without those facts, *Wisconsin Label Corp.* just does not apply here.

A window, whether new or a replacement, remains separate from a house. Thus, *Wisconsin Pharmacal* does not control.

B. The District Court's Ruling Ignores the Clear Meaning of "Property Damage", as Used by Both the Insurance Industry and Numerous State Court Rulings.

The ruling must be reversed because it is counter to the plain meaning of the phrase "property damage", as used in the insurance policies at issue in this action. Under Wisconsin law, insurance policies are contracts. *American Family Mut. Ins. Co. v. American Girl, Inc.*, 2004 WI 2, ¶¶ 23-24, 268 Wis.2d 16, 32-33, 675 N.W.2d 65, 73 (2004). As contracts, the parties' intent in drafting the words of those contracts is to be considered in examining what rights were conferred and obligations were imposed. *Id.* Wisconsin follows the majority of states, holding that the reasonable expectations of the policyholder must be protected. Id.

This analysis is particularly important when considering if an insurer has a duty to defend the policyholder, such as the issue involved in this action. Under Wisconsin law, doubts are resolved in favor of the policyholder and the insurer has a broad duty to defend, even if the insurer never has a duty to indemnify the policyholder. *Johnston Controls, Inc. v. London Market*, 2010 WI 52, ¶¶ 27-29, 325 Wis.2d 176, 190-191, 784 N.W.2d 579, 586 (2010).

Similar to the vast majority of insurance policies issued nationwide, the policies at issue in this action were drafted by the Insurance Services Office ("ISO") and then offered to ***10** policyholders, such as Kolbe, on a "take it or leave it basis". Eugene R. Anderson, *Insurance Coverage Litigation* §2.05, p.2-44 (2012 Supplement). "ISO develops standard policy forms and files or lodges them with each State's insurance regulators; most CGL insurance written in the United States is written on these forms." *Hartford Fire Ins. Co. v. California*, 509 U.S. 764, 772, 113 S.Ct. 2891, 2896,125 L.Ed.2d 612 (1993).

The ISO approved insurance policies purchased by Kolbe provide insurance coverage against "property damage" by obligating the insurer to "pay those sums that the insured becomes legally obligated to pay as damages because of… property damage to which this insurance applies." (Docket Number 84-2, p. 37, §I(1)(a).) The policies define the term "property damage" as "[p]hysical injury to tangible property, including all resulting loss of use of that property...." (Dkt. No. 84-2, p.51, §IV(17).) "The concept of property damage is central to CGL insurance coverage for construction risks." Lee H. Schidloksy, *Deconstructing CGL: Insurance Coverage Issues in Construction Cases* 9 No. 2 Journal of the American College of Construction Lawyers Journal 6 (2015).

The insurance industry has significantly revised the definition of "property damage" over the decades. Most notably, in 1986, ISO revised the basic CGL policy to make several key changes to make the langue providing coverage clearer and more explicit. *U.S. Fire Ins. Co. v. J.S.U.B., Inc.*, 979 So.2d 871, 879 (2007) (emphasis added). "The new provisions expressly clarified *in favor of coverage* certain key aspects of the BFPD [i.e., broad form property damage endorsement] that had generated disagreement and litigation." Clifford J. Shapiro, *The Good, The Bad, And The Ugly: New State Supreme Court Decisions Address Whether An Inadvertent Construction Defect Is An "Occurrence" Under CGL Policies* 25-SIM Construction Law 9, 3 (Summer 2005) (emphasis original).

***11** ISO documents "confirm[] that the 1986 revisions to the standard CGL policy not only incorporated the 'Broad Form' property endorsement but also specifically 'cover[ed] damage caused by faulty workmanship to other parts of work in progress; and damage to, or caused by, a subcontractor's work after the insured's operations are completed.'" U.S. Fire Ins. Co. at 879 (quoting Insurance Services Office Circular, Commercial General Liability Program Instructions Pamphlet, No. GL-86-204 (July 15, 1986)). These revisions were made in response to requests from the insurance industry and policyholders.

> [T]he insurance and policyholder communities agreed that the CGL policy should provide coverage for defective construction claims so long as the allegedly defective work had been performed by a subcontractor rather than the policyholder itself. This resulted both because of the demands of the policyholder community (which wanted this sort of coverage) and the view of insurers that the CGL was a more attractive product that could be better sold if it contained this coverage.

Id. At 879 (quoting 2 Jeffrey W. Stempel, *Stempel on Insurance Contracts* § 14.13[D] at 14-224.8 (3d ed. Supp.2007)).

This expansion of coverage was intended to guard against losses such as a roof leaking that damages a ceiling, a plumbing leaking that flooded a house, or a furnace that after being incorporated into a structure burns the house down. *See, e.g.,* Cypress Point Condominium *Assoc. Inc. v. Adria Towers. L.L.C.*, 441 N.J.Super. 369, 380-381, 118 A.3d 1080, 1087 (2015); *U.S. Fire Ins. Co.*, 979 So.2d at 879; *French v. Assurance Co. of America*, 448 F.3d 693, 705-706 (4th Cir. 2006). Because of the 1986 revisions, and ISO's notes about why the 1986 revisions were made, the vast majority of courts have held that construction defect claims are covered by the CGL insurance policy because those claims are "occurrences". Christopher C. French, *Construction Defects: Are They "Occurrences"?* (2011) 47 Goz. L. Rev. 1, 27-28. As a New Jersey court stated:

> ***12** [T]he 1986 ISO form includes a significant exception to an exclusion not contained in the 1973 ISO form. Due to this exception, we conclude that for insurance risk purposes, consequential damages caused by a subcontractor's faulty workmanship are considered differently than property damage caused by a general contractor's work.

Cypress Point Condominium Assoc. Inc.. 441 N.J.Super. at 379, 118 A.3d at 1087.

> The standard CGL policy form has been in a state of continuing development for decades, including major revisions in 1986. Courts hearing construction defect disputes have been particularly amenable to considering the historical development of CGL forms to determine the scope of coverage under present-day policies. The historical development of CGL forms reflects the efforts of the insurance industry to meet the perceived needs of the construction industry and to clarify and modify coverage as new risks have emerged.

Schidloksy, *supra,* at 8.

In fact, the extension of coverage by ISO's 1986 revisions for construction defect claims has been noted by the Wisconsin Supreme Court. "Cases in Wisconsin and in other jurisdictions have consistently recognized that the 1986 CGL revisions restored otherwise excluded coverage for damage caused to construction projects by subcontractor negligence." *American Family Mut. Ins. Co.*, 200 Wis.2d at ¶ 69, 268 Wis.2d at 53, 673 N.W.2d at 83.

Considering why ISO made revisions in 1986 and Wisconsin law mandating that an insurance policy must be interpreted according to the reasonable expectations of the insured leads to the conclusion that the District Court's ruling must be reversed. Why does a policyholder involved in the construction industry pay hundreds of thousands of dollars to secure insurance coverage in the first instance? The answer must be that the policyholder secured that coverage to have protection against claims that property other than that on which the policyholder was working was damaged. Contractors purchase insurance coverage to protect ***13** them against claims that their work damaged property other than their own work product; it is ***the*** reason why they purchase insurance coverage. French, *supra*, 46-48.

This underlying intent for there to be insurance coverage for "property damage" should now be enforced; there is no reason to re-write the grant of coverage in the insurance policies at issue in this action after everyone understood at the time that those policies were issued that they would provide coverage for property (allegedly) damaged by Kolbe's windows. The District Court's ruling would undermine that intent - and the reasonable expectations of the policyholder - by eviscerating coverage under insurance policies that have been issued as well as those insurance policies to be issued. *See Fitzgerald v. Meissner & Hicks. Inc.*, 38 Wis.2d 571, 579-580, 157 N.W.2d 595, 598-599 (1968) (stating that court decisions typically apply both retrospectively and prospectively). Upsetting this pre-existing risk allocation would undermine the policyholders' reasonable expectations of what insurance coverage they have and "would render the coverage provided under CGL policies largely illusory for contractors." French, *supra*, 47.

C. The District Court's Ruling is Counter to the Premise of the Economic Loss Doctrine.

While the analysis under the Economic Loss Doctrine ("ELD") for whether there is damage to property is a separate and distinct analysis for whether there is "property damage" for insurance coverage purposes, to the extent that these are related, the District Court's ruling undermines the ELD.

> The economic loss doctrine operates to restrict contracting parties to contract rather than tort remedies for recovery of economic losses associated with the contract relationship. *Vogel v. Russo,* 2000 WI 85, ¶ 15, 236 Wis.2d 504, 613 N.W.2d 177. The economic loss doctrine is a remedies principle. It determines how a loss can be recovered - in tort or in contract/warranty law. *It **does not determine whether an insurance policy covers a claim, which depends instead upon the policy language.***

***14** *American Family Mut. Ins. Co.*, 2004 WI at ¶ 35, 268 Wis.2d at 37, 673 N.W. at 75 (emphasis added).

Critically, the District Court failed to appreciate the difference between case law concerning *liability in the absence of a contract* and *insurance under a contract.* The ELD applies only as a measure of tort liability - that is, liability in the *absence of a.* contract. Insurance coverage, in contrast, constitutes at heart a set of responsibilities *based on* contract. The District Court's decision to rely on the ELD to *interpret contractual responsibilities* constituted clear error under Wisconsin law.

The ELD is based on the premise that the parties have a freedom of contract negotiation so that, as between themselves, they are able to decide what risks they do or do not wish to accept. A key foundation element is that the parties can obtain insurance coverage for that risk, particularly for well-known risks of their industry. "[A]mplication of the economic loss doctrine encourages the party with the best understanding of the attendant risks of economic loss, the commercial

purchaser, to assume, allocate, or ***insure against*** the risk of loss caused by a defective product." *Daanen & Janssen. Inc. v. Cedarapids. Inc.*, 216 Wis.2d 395, 410, 573 N.W.2d 842, 849 (1998) (emphasis added).

This focus on risk allocation, coupled with the policyholder being able to secure insurance coverage, led the Wisconsin Supreme Court to conclude that the ELD applies in the absence of contractual privity.

> Even if a commercial purchaser cannot detect product failures before they occur, it can at least anticipate problems and ***insure against them through purchasing insurance*** or allocating risk by contract. (Citation Omitted.) In this case, even if Daanen could not predict the pitman failure before it occurred, it could have anticipated production problems caused by equipment failures and guarded against such failures *by* ***purchasing insurance*** or through allocating these risks by contract.

***15** *Id.* At 411-412, 573 N.W.2d at 849 (emphasis added).

The Wisconsin Supreme Court has enforced the ELD, coupled with the ability to secure insurance coverage, as a way to protect consumers as otherwise "[c]onsumers would then be forced to subsidize or pay premiums for commercial purchasers who choose ***not*** to assume, allocate, or *insure* against their risk of economic loss. *Id.* At 412-413 (emphasis added). Thus, the ELD works only if insurance is available to the cover the risk allocated to and accepted by a party.

The District Court's ruling is directly counter to the ELD's premise that the parties can secure insurance coverage for the risks accepted by it. This, in turn, will hinder the parties' ability to allocate risk between themselves, as the ELD envisioned, because the parties would be unable to protect themselves for a risk that they would otherwise assume. The ruling would force the very same costs onto society that the ELD is meant to avoid.

Despite this, the District Court's ruling makes the ***assumption*** that Kolbe, and similarly situated policyholders, will not be able liable to consumers because the ELD will bar those claims. There is no certainty of that. The ruling deprives policyholders of insurance coverage protection while there remains a potential that they will be held liable to the claimants. Insurance coverage exists to provide protection against uncertainty. Exposing policyholders to tort liability while depriving policyholders of the ability to secure insurance coverage defeats the reasonable expectations of why any policyholder would pay money - sometimes millions of dollar - for insurance coverage in the first instance.

D. The District Court's Ruling Should be Overruled Because a Federal Court Sitting in Diversity Should Not Make New Wisconsin Law.

A federal court is sitting in diversity should not make new Wisconsin law. *A. W. Huss v. Continental Cas. Co.,* 735 F.2d 246, 253 (7th Cir. 1984). The District Court's ruling represents ***16** an extension of Wisconsin law by removing insurance coverage for virtually all construction defect claims and so should it be overruled. If affirmed, then any damage to any property could be, and would be, connected to the defective property so that there is effectively no insurance coverage for any construction defect claim in Wisconsin.

For example, if a roof collapses and damages the kitchen floor, then, there is no "property damage" because, according to the District Court's ruling, both are in the same house and so, in an integrated system. Such a result would be counter to the reasonable expectations of the policyholder and consumer as well as public policy in Wisconsin. Still, the District Court's ruling would be cited by insurers to deny coverage for damage caused by the roof to the floor. This would result in a massive restriction of insurance coverage in Wisconsin, the effects of which would be widespread and economically devastating.

The decision not to make new state law is particularly appropriate here where the vast majority of states have held that a construction defect claim is "property damage". U.S. Fire Ins. *Co.*, 979 So.2d at 880-881. Notably, the West Virginia Supreme Court recently held that a construction defect claim is "property damage", partially after surveying decisions of other states and concluding that a "majority" of states have found held that there is coverage for such a claim. *Cherrineton v. Erie Ins. Property and Cas. Co.*, 231 W.Va. 470, 479-81, 745 S.E.2d 508, 517-19 (2013). If Wisconsin wishes to "buck that tend", then a Wisconsin court should make that decision. "[A] federal court must apply the state law as declared by the highest state court or otherwise by the intermediate appellate court of the state. It has limited discretion to adopt untested legal theories brought under the rubric of state law." *Affiliated FM Ins. Co. v. Trane Co*, 831 F.2d 153, 155 (7th Cir. 1987).

17** This jurisprudence is particularly appropriate here where affirming the District Court's ruling would result in a significant restriction of insurance coverage and so create new Wisconsin law. This new law would be directly counter to Wisconsin's existing strong public policy of expanding, ***not restricting, insurance coverage, as reflected in Wisconsin (1) statutorily requiring entities in the construction industry to have insurance coverage and (2) statutorily allowing an injured party to sue an insurer directly.

1. The Stated Public Policy of Wisconsin is That Contractors *Must* Purchase and Maintain Insurance Coverage.

Wisconsin has a public policy of encouraging and expanding insurance coverage. Wisconsin ***requires*** contractors to have insurance coverage before they are able to work on residential construction. Wis. Stat. § 101.654(2); *see also* Wis. Stat. § 100.65.

An applicant for a certificate of financial responsibility ***shall*** provide to the satisfaction of the department proof of all of the following:

(a) That the applicant has in force one of the following:

1. A bond endorsed by a surety company authorized to do business in this state of not less than $5,000, conditioned upon the applicant complying with all applicable provisions of the one- and 2-family dwelling code and any ordinance enacted under s. 101.65 (1) (a).

2. ***A policy of general liability insurance*** issued by an insurer authorized to do business in this state insuring the applicant in the amount of at least $250,000 per occurrence because of bodily injury to or death of others or because of ***damage to the property*** of others.

Wis. Stat. § 101.654(2)(a) 2 (emphasis added).

This insurance requirement is based on the legislative determination that consumers are protected ***only if*** the contractors that they hire are insured against the construction defect claims.

18** Also, for public works projects, Wisconsin requires contractors to have proof of insurance.[3] This insurance requirement, built into the very structure of governmental construction contracts, reflects a legislative determinant that the people of Wisconsin themselves need to be afforded the protection of insurance coverage for government construction contracts. In fact, even the Wisconsin Supreme Court ***requires contractors performing work on its structures to maintain liability insurance, including property damage arising out of completed operations.[4] As this Court is asked to interpret what the Wisconsin Supreme Court might hold, it should take into account what the Wisconsin Supreme Court ***actually requires*** in terms of insurance. Ironically, the District Court's ruling ***presumed*** that the Wisconsin Supreme Court would consider contractors performing work on the Court's own projects to be uninsured for damage to the court structures,

even though Supreme Court actually requires them to have insurance coverage. Such an outcome is be directly counter to stated public policy of Wisconsin and so should be overruled.

2. Wisconsin Allows an Injured Party to Sue an Insurer, Even if the Insurance Policy Bars That.

The decision by the Wisconsin Legislature to proactively take measures to ensure that there is insurance coverage available to consumers is not limited to just construction activities. Unlike the majority of states, Wisconsin is a "direct action" state. Wis. Stat. § 632.24. In most states, pre-judgment third party claimant cannot sue the insurer because there is no privity of contract and the insurer is usually held not to have a tort duty to that claimant. *See, e.g., Royal Indem. Co. v. United Enterprises, Inc.*, 162 Cal.App.4th 194, 210-211, 75 Cal.Rptr.3d481,493- ***19** 494 (Cal. Ct. 2008); *see also* Dkt.No. 84-2, p. 46, § IV(3). However, in a "direct action" state, such as Wisconsin, a third-party clamant is ***statutorily authorized*** *to* sue the insurer directly. Wis. Stat. § 632.24; *see also Estate of Ott v. Physicians Ins. Co.*. 2008 WI 78, ¶¶ 31-32, 311 Wis.2d 84, 99, 751 N.W.2d 805, 812 (2008). This allows a consumer to secure a remedy for an alleged harm sooner than it otherwise could.

The District Court's ruling is counter to this public policy of expanding insurance coverage by denying insurance coverage for construction defect claims.

F. The District Court's Ruling Would Disrupt Innovations in the Construction Industry, Thereby Increasing the Cost of Housing.

The protection offered by an insurance policy extends beyond simply providing indemnity coverage to the policyholder against a third-party claim. An insurance policy provides a social peace that the District Court's ruling would destroy. Without insurance coverage for construction defect claims, there will be more litigation, not less. Given the strong acknowledged public benefit from the availability of insurance coverage, no one would benefits from a ruling that proactively eliminates the public benefit of insurance coverage.

If the District Court's ruling is affirmed, then consumers wanting to have a new roof installed on their home, or a new furnace installed, or new windows installed, or a new septic tank installed, would have no real way to protect themselves from damage caused to their homes. Roofs that leak, furnaces that burn down homes, windows that fail and damage drywall and paint, foundations that crack and cause structural collapse to the framing of a home, septic tanks that overflow - none of that property damage caused would be covered, and consumers would be limited to recovering from the assets of the contractors they hired. There would be no liability coverage for a factory burned down due to an improper electrical switch, a Supreme Court building flooded by negligently installed sprinklers, or a school with walls that collapsed from ***20** improper framing. In an industry populated primarily by family and small businesses, the resulting liabilities would devastate the contractors and, in most circumstances, leave the contractors bankrupt, their employees without jobs, and consumers without a remedy.

Separately, the District Court's ruling would harm the development of new products/techniques in the construction industry. Insurance coverage plays a vital role in protecting that innovation by allowing firms to develop new desired techniques/products that consumers want but, with the knowledge that, should other property be damaged, then insurance coverage will be available to protect them. Without insurance coverage, people would be less willing to take a risk and develop new products because they would be exposing themselves financially to risks that otherwise would be protected by insurance coverage. This, in turn, means that consumers would be deprived of the new products that they want. No one wins in this scenario.

G. The Ruling Deprives Policyholders and Consumers of the Protection Offered by Insurance Coverage.

The District Court's ruling will have several harmful effects when a policyholder, such as a contractor, is sued. If the policyholder is in bankruptcy, then the insurance policies are an asset of the bankruptcy estate and so still obligated to provide the promised insurance coverage. *In re Louisiana World Exposition, Inc.*, 832 F.2d 1391, 1399 (5th Cir. 1987); *see also* Dkt.No. 84-2, p. 46, § IV(1).

The significance of this contractual obligation on the insurer to honor its coverage obligations, even if the policyholder is bankrupt, is illustrated by the effects of a declining housing market as part of the "Great Recession". Too many contractors were forced to seek the protection of the bankruptcy court during that time period. If Wisconsin sees a similar number of bankruptcies occur again, then both consumers and policyholders will lose.

***21** The consumers would be harmed because they cannot recover money to remedy their construction defect claims. By definition, the bankrupt contractor would not have sufficient assets to pay the consumers for needed repairs. But, with insurance coverage, consumers would know that, should they prevail on their tort claims against the debtor (i.e., policyholder), then the debtor would not be "judgment proof" because the insurer must still satisfy any judgment/settlement. Society benefits when consumers are able to secure a remedy for an injury.

The policyholders would lose because they would be required to spend more of their own money to satisfy construction defect claims, which would deplete resources that the contractor could otherwise be used to satisfy other creditors. Real money was paid by policyholders to the insurers to secure insurance policies. Now, that money should not be deemed a waste. Insurers must honor the promises that they made when they voluntarily agreed to provide insurance coverage to a construction contractor doing construction work against construction defect claims; it is not only the right thing to do, it is the their legal obligation.

The ruling should be reversed because consumers and policyholders will be worse off if they are denied access to insurance coverage that the policyholders reasonably believed that they were purchasing when the paid the insurers money for that promised coverage.

22 V. *CONCLUSION

Amicus curiae United Policyholders respectfully requests that this Court reverse the decision of the U.S. District Court for the Western District of Wisconsin and remand for further proceedings.

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25 STATEMENT OF *AMICUS CURIAE

Pursuant to Rule 29(c)(5) of the Federal Rules of Appellate Procedure, I hereby certify:

A. a party's counsel did not author the brief in whole or in part;

B. a party or a party's counsel did not contribute money that was intended to fund preparing or submitting the brief; and

C. a person - other than the *amicus curiae,* its member, or its counsel - did not contribute money that was intended to fund preparing or submitting the brief.

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Footnotes

1 United Policyholders is submitting a motion seeking leave to file this brief in conjunction with this brief.

2 See Eugene R. Anderson et al, *Insurance Nullification by Litigation*, Risk Management, April 1994 at 56.

3 One example of this is the request from the Sauk County Emergency Management, Buildings & Safety for the "Courthouse East Entrance Refurbishment" project. The request specifies what insurance coverage is required and its amount. "Request for Proposal", ¶ 22.0 *https://www.co.sauk.wi.us/sites/default/fdes/…/front porch rfb.pdf* (February 16, 2016).

4 "Request for Bids", ¶ 23 *https://www.wicourts.gov/procurement/docs/scl4100.doc*

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