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THE EMPEROR HAS NO COMPLETED OPERATIONS

by DAN JACOBSON

In the Hans Christian Andersen classic *The Emperor's New Clothes*, swindlers convince the emperor that they could weave him a suit of clothes made out of fabric that would be "invisible to anyone who was unfit for his office, or who was unusually stupid." Once the new suit was weaved (out of nothing, as there was no such magic fabric), the emperor paraded through the city. The emperor, his ministers, and his subjects all pretended to see a fine suit of clothes, where they only saw the emperor's naked body, as they all feared to be revealed as being unfit for office or unusually stupid. Finally, a young child who was unfettered by such fear said, "But he hasn't got anything on."

Division Two of the First District Court of Appeal recently assumed the role of Andersen's young child when it exposed that the typical commercial general liability insurance policy's products-completed operations hazard section as being ambiguous to the point of naked confusion. In *N. Counties Eng'g, Inc. v. State Farm Gen. Ins. Co.*, 224 Cal. App. 4th 902 (2014), filed by Division Two of the First District Court of Appeal on March 13, 2014, the court pointed out that this ambiguity has existed for ages to the point of utter confusion. The *North Counties* court quoted what it called an "exasperated [1967 Supreme] court" discussing a policy clause similar to the one at issue in *North Counties*:

> [T]he plaintiff gave the defendant coverage in a single, simple sentence easily understood by the common man in the market place. It attempted to take away a portion of this same coverage in paragraphs and language which even a lawyer, be he from Philadelphia or Bungy, would find it difficult to comprehend. . . . An examination of [the insurance policy] involves a physical effort of no mean proportions. If [the reader] is possessed of reasonable physical dexterity, coupled with average mental capacity, he may then attempt to integrate and harmonize the dubious meanings to be found in this not inconsiderable package. A confused attempt to set forth an insuring agreement is later assailed by such a bewildering array of exclusions, definitions, and conditions that the result is confounding.

Id. at 926 (quoting *Ins. Co. of N. Am. v. Elec. Purification Co.*, 67 Cal. 2d at 689-70 (1967) (internal citations omitted)).

It is important to understand a few basic concepts about interpreting insurance policies. "While insurance contracts have special features, they are still contracts to which the ordinary rules of contractual interpretation apply." *Bank of the W. v. Super. Ct.*, 2 Cal. 4th 1254, 1264 (1992). "[A] policy provision will be considered ambiguous when it is capable of two or more constructions." *Brown v. Mid-Century*, 215 Cal. App. 4th 841, 858 n.8 (2013). "It is a well-settled rule of law that ambiguities in a written contract are to be construed against the party who drafted it." *Victoria v. Super. Ct.*, 40 Cal. 3d 734, 745 (1985). Since an insurance policy is drafted by the insurer, any "ambiguities" arising from the policy must be construed against the insurer.

In *North Counties* the general issue was whether State Farm Insurance had a duty to defend its insured. "An insurer must defend its insured against claims that create a *potential* for indemnity under the policy." *Scottsdale Ins. Co. v. MV Transp.*, 36 Cal. 4th 643, 654 (2005). So, an important issue was whether there was the potential for coverage under the policy's products-completed operations hazard section.



State Farm argued that there was no such potential. In fact, State Farm argued that the products-completed operations hazard section did not provide coverage at all, and that it was appropriately called the "products-completed operations *limit*." *N. Counties*, 224 Cal. App. 4th at 924 (emphasis added). This, even though State Farm's senior underwriter testified that the products completed operations section was "coverage"; and, in a pre-lawsuit letter, State Farm called the section "*coverage*." *Id.*

So, the insurer described its products-completed operations hazard clause, the type of clause that nearly fifty years ago the Supreme Court said that "even a lawyer, be he from Philadelphia or Bungy, would find it difficult to comprehend," as "coverage" in a couple of communications, and as a "limit" in another. Confused about whether the products-completed operations hazard clause is naked of meaning?

A brief deter to the Insurance Services Office ("ISO") is in order, so that one can understand why different property/casualty insurers often have policies that are worded exactly alike. The ISO is a private company that provides property/casualty insurance policy language to insurers throughout the United States. *See* www.iso.com. The ISO is best understood as "an insurance industry group." *Waller v. Truck Ins. Exch., Inc.*, 11 Cal. 4th 1, 41 n.2 (1995). It provides insurance policy "drafting services to approximately 3,000 nationwide property or casualty insurers. Policy forms developed by ISO are approved by its constituent insurance carriers and then submitted to state agencies for review. Most carriers use the basic ISO forms, at least as the starting point for their general liability policies." *Montrose Chem. v. Admiral Ins.*, 10 Cal. 4th 645, 671, n.13 (1995). While the *North Counties* Court didn't say whether the State Farm policy was an ISO form, it sure sounds like one.

The court cited the relevant language:

> [P]roducts-completed operations hazard: a. includes all . . . property damage arising out of your product or your work except products that are still in your physical possession or work that has not yet been completed or abandoned. The

> . . . property damage must occur away from premises you own or rent. Your work will be deemed completed at the earlier of the following times: (1) when all of the work called for in your contract has been completed . . . .

[Bolding omitted.] The policy defined, "Your work" as "work or operations performed by you or on your behalf; and materials, parts, or equipment furnished in connection with such work or operations." *N. Counties*, 224 Cal. App. 4th at 925. The declarations page showed a $2,000,000 policy limit for "Products-completed Operations." *Id.*

Breaking down the cited language the products-completed operations hazard clause provided $2,000,000 in coverage for two things, one was "your product," and the other was "your work"; but, not all of "your product[s]" or all of "your work." The policy excepted "products that are still in your physical possession or work that has not yet been completed or abandoned." So, in one comma-less sentence the clause attempted to give $2,000,000 of coverage, and to take away that very coverage. Along the way, the clause spiked itself with confusion in the following ways: (1) It didn't use commas to differentiate or distinguish anything, making the language at least difficult to understand; (2) It attempted to give coverage for a singular noun, "your product," and then tried to take away coverage for a plural noun, "products." That's confusing or nonsensical; (3) It used the disjunctive conjunction "or" when conjoining the two exceptions. This combined with the lack of distinguishing commas made it possible for the insured to think that only one or the other exceptions was operative.

So, there were purported "exclusions," tucked away amongst the products-completed operations hazard "coverage" clause, in confusing language, and State Farm's position was that the clause "was not a 'coverage'," but instead was a "limit." *Id.* at 925-27.

If the reader's head hurts, the reader is paying attention. Ready to line up with Andersen's child to declare that the products-completed operations hazard clause has no clothes?

In an article that attempts to clarify the products-completed operations hazard clause, Carl Stanovich, of IRMI Risk Management, says that when there is such a clause, "the C[ommercial] G[eneral] L[iability] insuring agreement promises to pay *only* if . . . property damage *occurs during the policy period*." Stanovich, "The Hazards of Products and Completed Operations: Understanding the Fundamentals," www.irmi.com/expert/articles/2006/stanovich10.aspx.

But, it is common for damage to manifest after a policy period. Examples include damages resulting from a roof that leaks or a product that blows up in January, when the policy period ended in December. In fact, the roof leakage example will almost never happen during the policy period, because it takes a long time to build a roofed building, it takes time for defectively installed roofing material to manifest its defects, and (in Southern California) it rarely rains.

So, what is included when an insured pays hundreds of thousands of dollars per policy period in premiums? The *North Counties* court said that the products-completed operations hazard presents, "complications, if not outright ambiguity." *N. Counties,* 224 Cal. App. 4th at 929. The property/casualty insurance industry should take heed of *North Counties*, elsewise brave insureds will rightfully proclaim that their hazards have no clothes.

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