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troller need not require reimbursement if the Bank's disclosure errors involved only "technical and nonsubstantive" violations that did not adversely affect the information provided to the consumer. Since its disclosure errors resulted from its officers' unfamiliarity with the Commentary and did not mislead or deceive the borrowers, the Bank asserted that TILA did not require the Comptroller to order reimbursement. The court, however, disagreed and held that the Bank's failure to disclose a composite interest rate defeated a central purpose of TILA: to enable borrowers to compare credit terms offered by other lenders.

Reimbursement Only for Loans Made Since "Immediately Preceding" Examination

TILA authorized the Comptroller to order reimbursement from the Bank to borrowers whom the Bank had erroneously disclosed the composite interest rate for loans made since the date of the "immediately preceding examination." The Comptroller conducted an examination of the Bank on December 31, 1987, neglecting to examine the Bank's compliance with TILA and Regulation Z. The Bank contended that TILA only authorized the Comptroller to order reimbursement for loans made since the 1987 examination, the "immediately preceding examination."

In contrast, the Comptroller argued that TILA authorized it to order reimbursement on the basis of loans the Bank had made since June 30, 1985, the date of the last previous examination in which the Comptroller had examined the Bank's compliance with TILA and Regulation Z. Further, the Comptroller contended that the legislative purpose of this portion of TILA required the court to interpret the phrase "immediately preceding examination" to refer to the immediately preceding examination of the same type as the one during which the Comptroller discovered the violations.

The court, however, agreed with the Bank that TILA only authorized the Comptroller to order reimbursement for loans made since the 1987 examination. The court noted that the language of the statute referred only to the immediately preceding examination and did not distinguish between examinations of different types. Since the language of the statute was clear, the court held that it meant exactly what it stated. Consequently, the Comptroller could only order reimbursement on the basis of loans made since the date of the December 31, 1987 examination.

Affirmed in Part; Reversed in Part

The court affirmed the Comptroller's finding that the Bank's failure to disclose a composite interest rate constituted a violation of TILA and Regulation Z. In addition, the court found that the Bank's failure to make such disclosures on almost 700 loans over a two year period constituted a "pattern or practice" of violations. However, the court vacated the Comptroller's order of reimbursement for the period from January 31, 1985 to June 30, 1988 and remanded the case to the Comptroller to consider whether or not to order reimbursement for the discounted variable interest rate loans made from December 31, 1987 to June 30, 1988. ❖

— *Colby M. Green*

Announcement

Fraud Hotline

Consumers who receive telephone calls or postcards telling them they have won prizes can now call a toll-free number to find out if the offer is fraudulent. The National Fraud Information Center, at (800)-876-7060, has been established by a coalition of groups battling telephone fraud. The hotline operates from the National Consumers League from 10 a.m. to 4 p.m. Eastern time.

Insurance Liability Occurs at the Installation of a Potentially Dangerous Product

In ***Eljer Manufacturing, Inc. v. Liberty Mutual Insurance***, 972 F.2d 805 (7th Cir. 1992), the United States Court of Appeals for the Seventh Circuit held that physical injury to tangible property from a defective plumbing system occurred at the installation of the product in a house, not when the product actually malfunctioned and caused physical damage.

Insurance, Plumbing, and Water

Between 1979 and 1986, U.S. Brass, a subsidiary of Eljer Manufacturing Inc., manufactured and sold a plumbing system called "Qest" to plumbing contractors. One-half to three-quarters of a million Qest systems were installed behind walls, below floors, or above ceilings in houses and apartments. Complaints about leaks began within a year after the installation of the first units. Eventually, about 5 percent of the installed systems failed. By 1990, home owners and contractors filed several hundred lawsuits involving almost 17,000 Qest systems.

The suits filed by the contractors and homeowners presented basically two types of claims. The first claim based its recovery on actual system leakage, which caused the home to be water damaged, uninhabitable, or reduced in value. The second claim, based recovery not on actual system leakage, but rather on the homeowner's replacement of the system, which caused deprivation of home usage during the replacement period.

Liberty Mutual Insurance ("Liberty") issued Eljer a series of annual policies between 1979 through 1988. Travelers Insurance provided Eljer excess coverage between 1982 and 1986. These policies covered property damage liability accidentally caused by Eljer or its subsidiaries. Eljer brought this suit to the United States District Court for the Northern District of Illinois against its primary insurer, Liberty, on the issue of whether its insurance covered the claims based on the plumbing system's failure.

Lower Court Finds Limited Liability

The district court held that water damage from the leaks constituted property damage, and that the policy in force at the time of installation covered the loss-of-use claims.

Eljer requested declaratory judgment to determine the scope of insurance coverage regarding the physical injury to tangible property and the loss-of-use concerning tangible property not physically injured. Eljer argued that all of the "property damage" inflicted by the defective Qest systems occurred during the installation of the systems in years that Liberty's insurance policies were in force. Eljer contended that physical injury to property occurred at the time of installation of the Qest system in the buyer's home, not when it began to leak, was replaced, or reduced the home's value. Liberty, however, argued that the property damage did not occur until the system actually leaked or when the homeowner, realizing that the Qest system reduced the value of his home, replaced the system.

The district court agreed with Liberty that property damage did not occur at the installation of the defective system and concluded that property damage occurred when the leak occurred or at the time of repair or replacement in anticipation of a leak. Eljer appealed the district court's ruling to the United States Court of Appeals for the Seventh Circuit. Liberty and Travelers appealed, contending that the district court should not have ruled on the loss-of-use claims with no leak because that issue had not been presented to the court.

The Ticking Time Bomb Rule

The Seventh Circuit Court of Appeals reversed the district court, holding that Eljer was not entitled to a declaratory judgment about the loss-of-use claims. Furthermore, the Seventh Circuit found that Eljer was entitled to insurance coverage under the "incorporation doctrine," where a potentially dangerous product is incorporated into another structure. The appellate court also found that the lower court misinterpreted the definition of property damage liability in the industry-wide standard-form insurance policy known as Comprehensive General Liability Insurance ("CGL").

The appellate court focused on the conflict between the connotations of the term "physical injury" and the objective of insurance. The court looked at the contractual language of both a 1966 CGL policy and an updated 1973 version which "incorporated" both physical injury and loss of use. The court concluded that the drafters of the 1973 version intended "physical injury" to mean loss that results from physical contact or physical linkage. Such linkage occurred when a potentially dangerous product was "incorporated" into another, eventually causing physical injury like a ticking time bomb.

The court supported its incorporation doctrine by first analogizing it to fixtures in property law, when improvements to property are made and cannot be removed without damaging the property. Second, the court looked at intentional and unintentional torts and distinguished touching and non-touching torts (loosely physical versus economic damages). Historically, people did not claim a loss in instances in which their property had not been physically damaged. The court went on to explain that the growing demand for insurance against liability for loss of use unaccompanied by "physical injury" set the stage for the drafting of a new, broad definition for "physical injury" in the 1973 CGL policy.

The court of appeals further noted that this new definition of "physical injury" satisfies the objective of insurance to spread risks. Parties to insurance contracts want to avoid risk and will pay a premium to avoid the small possibility of large loss. Once a risk becomes a physical certainty, insurance has no function. In this instance, the court found both Eljer and Liberty to be sophisticated business parties. Between such sophisticated business parties, the term "physical injury" was meant to distinguish between physical and non-physical injury. As a result, the court's broad interpretation of the term allowed the policy coverage to be real and not illusory.

The Seventh Circuit next examined the incorporation issue in relation to New York and Illinois law. The court found that New York courts accepting incorporation under the 1966 CGL policy but found little New York law interpreting the 1973 version. The majority concluded that Illinois law provided little guidance on the 1973 definition of "physical injury." Because of the lack of clarity in previous decisions of the Illinois Appellate Court, First District, and the Illinois Supreme Court, the Seventh Circuit relied on *Marathon Plastics, Inc. v. International Ins. Co.*, 161 Ill.App.3d 452 (4th Dist. 1987) and *Elco Industries, Inc. v. Liberty Mutual Ins. Co.*, 90 Ill.App.3d 1106 (1st Dist. 1980) for support of the incorporation doctrine. In both *Marathon* and *Elco*, the absence of physical injury in the normal sense was immaterial for liability in the context of incorporation.

Therefore, Illinois case law, the drafting history of the property-damage clause, and the parties' understanding of the liability contracts persuaded the Seventh Circuit that the incorporation of a defective product into another product inflicts "physical injury" on the latter product at the moment of incorporation. The Seventh Circuit thus reversed the district court judgment and remanded the case for entry of a judgment for Eljer.

The Contamination Theory

Judge Cudahy's dissent stated that an accurate reading of the contract policy language and Illinois cases revealed that mere installation does not constitute physical injury to property. First, Judge Cudahy contended that the words "physical injury" must be given a literal, plain sense meaning. The judge further argued that the purpose of insurance does not extend to risks that were not bargained for ahead of time. In addition, the court noted that the relevant parties for interpreting the language of the contract are Eljer, Liberty, and Travelers, and not the drafters of the CGL standard policy. ❖

— *Sharon Hannaford*

Bank Cannot Terminate Credit Card Agreement with Store Involved in Bankruptcy Proceedings

In ***Citizens and Southern National Bank v. Thomas B. Hamilton Co.***, 969 F.2d 1013 (11th Cir. 1992), the United States Court of Appeals for the Eleventh Circuit held that a merchant bank could not terminate a credit card agreement with a merchant who had filed for reorganization under chapter 11 of the Bankruptcy Code. The court affirmed the decisions of the bankruptcy court and the district courts in finding that the agreement in question did not have the primary purpose of providing financial accommodations, and therefore the bank could not terminate it after a bankruptcy filing.

Credit Card Merchant Agreement

Thomas B. Hamilton Co., Inc. ("Hamilton") was a retail merchant which had an ongoing credit card agreement with Citizens and Southern National Bank ("C & S"). This agreement allowed Hamilton to accept the MasterCard or Visa credit cards presented by its customers. C & S, as the merchant bank, would purchase the sales drafts from these retail transactions at a discount agreed to by both parties, which usually amounted to 96 percent of the transaction amount. C & S paid Hamilton within a few days of the purchase by direct deposit into a commercial checking account that Hamilton maintained at C & S. The bank would then present the sales drafts to the card-issuing bank, which would arrange for a transfer of funds from MasterCard or Visa to C & S, and bill the cardholder for the amount of the purchase.

In the event that a valid cardholder disputed an item on his bill, the card-issuing bank would have a right of chargeback against the merchant bank, in this case C & S. The agreement between C & S and Hamilton provided that under certain circumstances C & S would be able to pass this chargeback on to Hamilton. Situations in which C & S would have this right included returned merchandise, illegible sales drafts, and any other situation which may have been caused by Hamilton. The agreement provided three ways for C & S to protect itself from being billed for a chargeback that Hamilton could not or would not cover: it could deduct amounts owed from Hamilton's checking account; it could demand prompt payment for the chargeback amount; or it could hold a portion of the payments it owed Hamilton on reserve to cover future chargebacks.

In June 1989, Hamilton filed for chapter 11 reorganization. C & S required Hamilton to reapply for a credit card merchant agreement and rejected its application because of Hamilton's uncertain financial future.

The Dispute

Section 365(c)(2) of the Bankruptcy Code does not allow a party to an executory contract to terminate that contract solely because of another party's bankruptcy filing, unless the contract is "a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor." C & S argued that the credit card agreement was an extension of financial accommodations by C & S to Hamilton, and the bank could therefore terminate it upon Hamilton's bankruptcy filing. Hamilton contended that the agreement was not a contract for financial accommodations, and therefore Hamilton's trustee in bankruptcy could assume it.

Not a Contract to Extend Financial Accommodations

The court looked both at precedent and at the legislative history of the Bankruptcy Code in concluding that the agreement between Hamilton and C & S was not a contract to extend financial accommodations. The court determined that the term "financial accommodations" should be narrowly construed to mean "the extension of money or credit to accommodate another." In defining the term this way, the court said a distinction must be made between contracts whose primary purpose was to extend some sort of credit and contracts in which some extension of credit was merely incidental to a larger purpose.

Here, the court found that the agreement between Hamilton and C & S was for the sale of credit card sales drafts. Hamilton could sell its products to credit card customers, and C & S could make a small profit on these sales as the merchant bank. The real credit was extended from the credit card issuing bank to the consumer; the issuing bank bore the risk of nonpayment of a valid charge by a consumer. The terms of the agreement between C & S and Hamilton did not contemplate any extension of credit from C & S to Hamilton. Any credit that may have been extended to Hamilton in this arrangement was incidental to the larger purposes of the agreement.

The court further noted that there was not a significant risk that C & S would be harmed by a continuing relationship with Hamilton. The two parties had enjoyed a good relationship for several years, and Hamilton did not owe C & S any money. The court reminded C & S that the terms of the