OLSON GOOD
ATTORNEYS AT LAW

WWW.OLSON-GOOD.COM

South Carolina Attorneys at Law

clay.olson@olsonfirm.com

843-654-1022

A DISCUSSION ON INSURANCE COVERAGE FOR CHINESE DRYWALL CLAIMS

C. CLAY OLSON

Chinese Drywall is becoming a household name, referring to certain drywall products manufactured in China and imported into the US between 2004 and 2008. A relatively new trend in the construction defect sector of the law, consumer complaints begin surfacing during the years 2007 and 2008. The consumer complaints originated in Florida, causing many to speculate that the drywall might be the result of a deficit in availability of traditional product due to the millions of repairs elicited by the hurricane seasons which plagued the country in 2003, 2004, and 2005. As complaints poured in from Louisiana and Texas, the theory on the products origin became widely accepted.

From a property damage perspective, most consumers complained that strange, sulfur-like odors were coming from certain areas of the home. In addition, preliminarily studies suggest that the subject drywall emits a sulfur compound responsible for the corroding of electrical wiring, HVAC components, and certain household appliances in those structures that have been restored or rebuilt with Chinese-manufactured drywall. While the cause of these problems has yet to be fully determined, the drywall at issue appears to emit gases such as carbon disulfide, carbonyl sulfide, hydrogen sulfide, and diethyl sulfide. While certain physical maladies have been reported by some homeowners, this discussion will not focus on that aspect of the controversy.

Several lawsuits have been filed on behalf of consumers. The suits cite studies performed by ENVIRON, a consulting firm retained during initial litigation, as well as public health studies which have been produced at both state and federal levels. Litigation involving the use of Chinese drywall alleges that it is defective because it smells like "rotten egg" and emits a variety of harmful toxins that can corrode and damage metal components such as HVAC coils and doorknobs.

The construction and insurance industries have been on a collision course for years as a direct result of one common antagonist: the unhappy property owner. These owners come in all shapes and sizes, as some are single family residential homeowners, while others are corporate entities that rely on the contractors for the infrastructure within which they conduct their businesses. A common enemy does not always produce a united front, however, as evidenced by positions taken by insurers and their policyholders within the construction industry. At the heart of these disputes between insurance carriers are lawsuits against businesses in the building trades, including developers, contractors, and materials suppliers, which allege "occurrences" which cause tangible, physical damage to property.

The standard CGL defines the term "occurrence" as follows: "the continued or repeated exposure to substantially similar harmful conditions". Many courts have interpreted occurrences to be

"unexpected and unintended" by the contractor or subcontractor. Further analysis requires the unexpected damage to extend beyond the work or work product of the insured.

POLICY EXCLUSIONS AND LEGAL THEORIES APPLICABLE TO CHINESE DRYWALL

There are several standard CGL policy exclusions that may serve as a bar to coverage in Chinese drywall cases. Because the notion of defective drywall from China was not contemplated during the installation period(s), there is current speculation as to how "standard" and non-specific exclusions might seek to limit coverage. The situation is analogous to CGL policies which were underwritten in the 1990's, immediately prior to the synthetic stucco litigation which involved dozens of manufacturers, applicators, as well as general contractors that chose to install the product on the exterior of structures. While there is now a common "EIFS Exclusion" incorporated beyond the terms of the insuring agreement between builders and carriers, this was not the case until the product was declared to be defective.

POLUTION EXCLUSION

Specific jurisdictions have treated the pollution exclusion differently. Traditional environmental claims have seen the exclusion used successfully in most instances. The construction defect claims regarding Chinese drywall are, arguably, non-environmental in nature. Things are never black and white, however, and different jurisdictions have interpreted the exclusion to reach conflicting results.

Pollutants are defined in policies as "solid, liquid, gaseous or thermal irritant or contaminant, including smoke, vapor, soot, fumes, acids, alkalis, chemicals, and waste. Waste includes materials to be recycled, reconditioned or reclaimed." The 5th Circuit ruled in 2008 that a particular pollution exclusion clause applies whenever a pollutant causes harm by a physical mechanism enumerated in the policy, irrespective of where the injury took place or whether the pollutant was released into the environment. *Noble Energy, Inc. v. Bituminous Cas. Co.*, 529 F.3d 642 (5th Cir. 2008).

The definition of a pollutant can be determined by the actual substance being released, such as carbon monoxide. (Carbon Monoxide a pollutant and subject to the exclusion, see *Reed v. Auto-Owners Ins. Co.*, 667 S.E.2d 90 (Ga. 2008). *Whittier Properties, Inc. v. Alaska Nat. Ins. Co.*, 185 P.3d 84 (Alaska 2008) involved a propane leak and the policyholder's contention that the substance (petroleum) was not, in and of itself, a pollutant. The court concluded in favor of the insurer's exclusion, reasoning that when "gasoline escapes or reaches a location where it is no longer a useful product, it is fairly considered a pollutant." *Whittier Properties*, 185 P.3d at 91.

MOLD OR FUNGI EXCLUSION

The "mold exclusion" excludes coverage for bodily injury or property damage relating to the inhalation, ingestion or exposure to fungi, mold or bacteria within a structure. Consider the following case from Florida, which involved a suit against a contractor alleging mold related damages. In *Empire Indemnity Ins. Co. v. Winsett*, 2009 WL 1178516 (C.A. 11 (Fla.)), the Eleventh Circuit Court of Appeals reviewed a factual pattern in which it appeared that the mold growth was a product of the builder's failure to install a vapor barrier. The Court, applying Florida law, found that *even if the mold growth was caused by a covered preceding event*, the clear and unambiguous meaning of the language of the exclusion

nevertheless barred coverage for the claim. Thus, the moisture related damages to property as a result of negligent installation of the barrier would be deemed covered, although the production of harmful elements to the air were not a covered element of otherwise covered work. Current opinion regarding the scope of injuries attributable to Chinese Drywall will likely deem that these damages fall outside the mold exclusion. While there is some organic matter involved, it is not congruent with those elements covered by the mold and fungi exclusion.

THE YOUR WORK EXCLUSION

This exclusion bars coverage for damage to the policyholder's work. The definition of "Your Work" includes the integration of materials, parts or equipment furnished as part of the work. "Products-Completed Operation Hazard" is defined as "All bodily injury and property damage occurring away from premises…….. arising out of your product or your work except: 1) products that are still in your physical possession; and 2) work that has not yet been completed or abandoned.

An important exemption to this exclusion involves coverage for damage arising from work performed on behalf of the insured by a sub-contractor. So long as the property damage arises out of a lower-tier contractor's work, materials, or design, the "your work" exclusion will not limit coverage for defects alleged against a general contractor. As such, there may be instances where a general contractor could be covered for damage to the building as a whole by virtue of the fact that the defective drywall was installed by a subcontractor. The subcontractor exclusion has been the subject of much litigation, and the national trend is currently favoring coverage for negligent work of a subcontractor. "Plainly, an interpretation of the policy which views the term "occurrence" categorically to preclude coverage for the simple negligence of a subcontractor subverts the plain language and purpose of the CGL part of these policies." (Mississippi in Architex v. Scottsdale 2/10/2010 reversing a lower court ruling that a subcontractor exclusion allowed for coverage to be denied when the suit's pretext was faulty work of a subcontractor).

THE SISTERSHIP EXCLUSION (RECALL OF DEFECTIVE PRODUCTS)

This exclusion bars claims for expenses associated with the repair or replacement of a product when it has been withdrawn from the market. Thus, if the insured is a distributor of building materials, this exclusion is of particular importance. It should be noted, however, that the exclusion does not exclude coverage for the actual damage caused by the product itself. *See. e.g. Centillium Communications, Inc. v. Atlantic Mutual Insurance Co.*, 528 F. Supp. 2d 940 (N.D. Cal. 2007).

In light of the resolution introduced in the U.S. Senate seeking to impose a recall of all Chinese drywall, this exclusion may serve to bar claims associated with such a recall. However, the Sistership exclusion will not function to bar claims relating to the repair, removal and/or replacement of defective drywall if there is no general recall.

ENDORSEMENTS WHICH MIGHT LIMIT COVERAGE

KNOWN OR CONTINUOUS INJURY

This endorsement prevents coverage for losses of which the insured is aware prior to the policy inception date. Again, the insured's knowledge of the defective nature of the drywall is an issue. The

purpose of the exclusion is to prevent coverage for claims alleging damage to property that has not been physically injured arising out of a defect or dangerous condition in the named insured's product or work. In other words, if the drywall makes the building uninhabitable, this exclusion would prevent coverage for the claim against the named insured. This exclusion applies only if the building can be restored to use by the replacement or removal of the work product. This means that if the building can be again made habitable by the removal of the defective drywall, the exclusion will apply. But, if the building cannot be used again even after the drywall has been removed and replaced by non-defective drywall, the impaired property exclusion is not applicable.

This endorsement will be important in claims that may arise from construction occurring after a reasonable and prudent contractor should have known about the problems associated with Chinese Drywall. In sum, restrictions remain limited to known products which are deemed defective at the relevant coverage period. This doctrine is subject to the state of mind and knowledge of the contractor who has installed the product, specifically centering along knowledge of inherent dangers.

CONCLUSION AND LESSONS TO BE LEARNED

Insurance coverage is not understood by most lawyers or insurance agents. While contractors might be aware that some items are not covered under a policy, it is a truly impossible burden for a contractor to keep up with the day to day shifting of case law, public policy, and the other complications which make this such an unknown risk. Contractors that are involved in Southeastern projects should make certain that they buy products from suppliers that they trust. Further, contractors need to make sure that their agents are more than brokers of insurance products lacking independent knowledge of relevant construction issues. Chinese Drywall is like EIFS in that there is much uncertainty regarding the concentration of the problem. Risk transfer protocol such as requiring suppliers and subcontractors to sign contractual obligations which require indemnity and additional insured treatment are key in all building environments. Properly drafted contracts and administration of contract formalities can alleviate the construction professional from dealing with the headaches contained within a CGL policy of insurance.