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by
Alan R. Lyons, Esq.

Herrick, Feinstein LLP

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Commentary

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Alan R. Lyons, Esq.

[Editor's Note: Alan R. Lyons is counsel with the law firm of Herrick, Feinstein LLP with offices in New York City, Newark and Princeton. Alan Lyons specializes in insurance coverage and reinsurance litigation. John Cleaver, a summer associate at Herrick, Feinstein in 2011 and an incoming first-year associate at Herrick in the fall of 2012, assisted in the preparation of this article. Any commentary or opinions do not reflect the opinions of Herrick, Feinstein or Mealey's Publications. Copyright ©2011 by Alan R. Lyons. Responses are welcome.]

The massive home-rebuilding efforts that followed the devastating 2004 and 2005 hurricane seasons in the Gulf region of the United States created a huge demand for drywall. Most of it came from China. Along with the 550 million pounds of Chinese drywall came a host of problems, as the Chinese drywall was largely corrosive and tended to emit sulfur, with the region's hot, humid climate accelerating the speed at which it degraded and emitted sulfuric gases.

The problems resulting from the installation of Chinese drywall are myriad. They run the gamut from houses smelling of rotten eggs to the corrosion and failure of electronic appliances and wiring, and from allegations of various health ailments to issues arising from unregulated and perhaps fraudulent businesses promising remediation.

Homeowners sought coverage under their insurance policies. Manufacturers and installers of the drywall, meanwhile, made huge payouts to affected homeowners and then sought coverage from their liability carriers. The multi-million-dollar question is whether the insureds are entitled to coverage, or whether various policy exclusions — pollution or contamination exclusions most frequently, but also gradual or sudden loss exclusions, latent defect exclusions, and faulty materials exclusions, among others — will apply.

The results from the Gulf states' courts are mixed but, as of this writing, are generally leaning toward denying coverage. Courts in Virginia and Mississippi have so far found for the carriers, a Florida court has found for the insured in a third party case, and Louisiana case law has been inconsistent across various courts and, therefore, less predictable than outcomes in other jurisdictions. To date, the sample size is relatively small, and like all litigation, coverage actions are fact-sensitive and turn on case law in the various jurisdictions. As a general matter, however, the courts appear to be getting it right, siding with the carriers and recognizing and honoring one or more policy exclusions.

This emerging issue is of huge interest to the insurance industry as we enter new territory. To be sure, until the law in this area becomes more settled there will be more questions than answers. Chief among them: With this new kind of pollutant that places pollution exclusions in a new context, will courts read the exclusions literally, or will they look behind the policy language to divine the purpose of the exclusions? And will the courts distinguish between indoor pollution and outdoor pollution, creating a kind of indoor/outdoor test?

I. Possible Coverage Exclusions

Perhaps the most contentious exclusion at issue is the "Pollution or Contamination Exclusion." The term

pollutant is typically defined in the policies, but the definition usually does not list what substances actually qualify as pollutants. Case law addressing this exclusion often hinges on whether a court interprets it to apply only to traditional environmental pollution such as pollution of the soil or groundwater. If so, then damage caused by pollution inside a building, such as lead paint, carbon monoxide, and sulfur-emitting drywall, would likely be covered by the insurance policy.

The "Faulty Materials Exclusion" generally excludes all damages resulting from materials with a defective character. This exclusion invokes the question of whether the sulfuric emissions render the drywall faulty, even if the drywall performs its basic purpose as drywall. If so, then the exclusion would likely apply.

The "Faulty, Inadequate, or Defective Planning Exclusion" is similar to the "Faulty Materials Exclusion," but is more concerned with the installation, design, or construction of the material rather than the character of the material itself. This exclusion, though, presents a similarly confounding question: did the planning of the drywall installation ostensibly achieve what it set out to achieve in erecting drywall, notwithstanding the gaseous emissions? If so, then the exclusion would likely not apply.

Insurers have sought to invoke the "Gradual or Sudden Loss Exclusion" to exclude coverage for loss caused by the corrosion. With Chinese drywall, the issue then becomes somewhat of a chicken-and-egg conundrum: did the corrosion cause the damage, or is the corrosion itself the damage? If the corrosion is the cause of the damage, then the exclusion would likely apply.

The "Latent Defect Exclusion" excludes damage that is not apparent or visible. The courts have focused their analyses of this exclusion on whether the damaged property itself — here, the house in question — can be said to possess this latent defect. The damage to a house thus must be examined in terms of the drywall's relationship to that house; in other words, is drywall integral to the house itself, such that the latent defect can be said to be the house's latent defect. If so, then damage to the house will likely be excluded from coverage.

The "Ensuing Loss Clauses" differ from the others in that they do not exclude from coverage certain kinds of damage. Rather, when a non-covered event happens, these clauses *provide* coverage for events that arise from that non-covered event that would otherwise be covered by the policy. For example, if, because of corroded wiring, a home's kitchen burned down, then the losses from that fire may be covered under an ensuing loss clause even though corrosion is a non-covered event.

II. Chinese Drywall Jurisprudence — Differing Viewpoints and Shifting Sands

Chinese drywall-related coverage cases from four states — Virginia, Mississippi, Florida and Louisiana — seem most instructive at this writing. Those states are geographically relevant based on where the bulk of the Chinese drywall was used, and their courts' findings, in the aggregate, are emblematic of the disparate treatment of insureds' claims for coverage and carriers' defenses revolving around various exclusions. At this writing, courts in Virginia and Mississippi have so far found for the carriers in two first party cases. The Florida courts have not yet ruled in first party cases but found for the insured in a relevant third party case. Various Louisiana courts, meanwhile, have issued a gumbo of mixed opinions. A further look at some of the cases is warranted.

A. Virginia

The Virginia federal courts have declined to read into the exclusions any conditions that might distinguish between traditional environmental pollution and other kinds of pollution — an analysis that, at least for now, has made that jurisdiction carrier-friendly.

In the first party case Travco Ins. Co. v. Ward,[1] the Eastern District of Virginia reasoned that "[b]ecause the harm was caused by the release of a pollutant, the pollutant exclusion applied." The court invoked the precise language of the exclusion and found that although the Chinese drywall itself may not have been a contaminant or a pollutant, the gases it released were.

Similarly, in the third party case Nationwide Mut. Ins. Co. v. Overlook, LLC,[2] the Eastern District of Virginia restated the controversy over judicial interpretation of the Pollution Exclusion, but ultimately decided that the exclusion applied to household pollutants such as the sulfuric gases at issue. The court referenced the rationale in Travco and declined to "reformulate a contract" for the parties, holding that "to construe such an exclusion as only applying to traditional environmental pollution

would require this Court to interject words into the writing contrary to the elemental rule that the function of the court is to construe the contract made by the parties . . . ." The court also cited to prior Fourth Circuit holdings that the Pollution Exclusion is neither ambiguous nor subject to a reasonableness test. The Nationwide court held that the Pollution Exclusion did not distinguish between traditional environmental pollution and sulfuric gas released inside a building.

Most recently, the Eastern District of Virginia followed its earlier decision in Nationwide and held that the absolute pollution exclusion in general liability policies was not limited to traditional environmental pollution, but rather applied to exclude coverage for property damage caused by sulfur gases emitted from the drywall.

B. Mississippi

Mississippi case law — as embodied in two recent opinions from the Southern District of Mississippi, in first party cases — is developing as similarly favorably to carriers.

In Bishop v. Alfa Mutual Ins. Co.,[3] the court held that the Contaminant Exclusion excluded damage caused by the drywall emissions because, as in Travco, "contaminant" was defined as a substance that "was not generally supposed to be where it was located . . . and [injured] people, property, or the environment." The Bishop court distinguished its opinion from that in a case from neighboring Louisiana, In re: Chinese Drywall, by reasoning that because the exclusion for losses caused by contaminants did not appear in the context of a Pollution Exclusion, it did not matter whether sulfuric gas was a traditional environmental pollutant. The Bishop court listed various definitions of "contaminant" and concluded that sulfuric gas was consistent with each. Further, the court found that the Ensuing Loss provision did not cover the plaintiffs because their alleged losses, including illnesses and medical bills, would not have been covered by their policies in the first place.

In Lopez v. Shelter Ins. Co.[4] the Southern District of Mississippi found that two exclusions — those involving both faulty materials and contaminants — barred coverage for damages sustained from the Chinese drywall. The court reasoned that the insured's complaint itself alleged that the Chinese drywall was faulty material, thereby squarely invoking the Faulty Materials Exclusion. The court went on to state that the Contaminant Exclusion applied for virtually all of the same reasons as in Bishop.

C. Florida

The most relevant Florida Chinese drywall coverage case, at this writing, analyzed a claim made in a third party case and, notably, was decided in favor of insured.

In Auto-Owners Insurance Company v. American Building Materials, Inc.,[5] the Middle District of Florida found that the Pollution Exclusion did not apply. Citing the precise language of the policy in question, the court reasoned that "[f]or the exclusion to apply, the alleged 'pollutants' at issue in the underlying lawsuit must be [a]t or from any site or location on which you or any contractors or subcontractors . . . are *performing operations*." Thus, the court did not need to reach the question of whether sulfuric gases emitted from the drywall were "traditional environmental pollutants," but instead held that because the pollutants were released *after* the installation of the drywall, the exclusion did not apply.

D. Louisiana

Louisiana case law regarding the pollution exclusion had been consistently insured-friendly until a recent carrier-friendly ruling, which will likely be appealed by the spurned insured based on how far the decision departed from earlier cases. (More on the outlier case below).

In Finger v. Audubon Insurance Co.,[6] a first party case, a Louisiana state court held that none of the pertinent exclusions applied. The court heeded the rationale of Doerr v. Mobil Oil Corp., an earlier Louisiana Supreme Court decision which had held that the Pollution Exclusion applied only to traditional environmental pollution, but not to gases released by sub-standard building materials. Further, the Finger court held that the Gradual or Sudden Loss exclusion did not apply because the corrosion did not cause the damage, but was the damage itself. Similarly, the court held that the "Faulty, Inadequate or Defective Planning" exclusion did not apply because the drywall itself performed its sole expected function as drywall, notwithstanding any unpleasant gases emanating from it or any damage to appliances and wires.

In In re: Chinese Manufactured Drywall Products Litigation,[7] a multi-district litigation involving ten separate

class actions (to which we alluded in the Mississippi-centric section above), the Eastern District of Louisiana federal court performed an even more extensive analysis of the exclusions and held that three of the five did not apply. First, the court held that although the Latent Defect Exclusion presented a "close call," the insurers simply failed to meet their burden of showing that it applied. Second, in analyzing the Pollution Exclusion, the court followed the reasoning in Finger and held that the exclusion did not apply because sulfuric-acid emitting drywall is "outside the ambit of the Louisiana Supreme Court's concern with and focus upon environmental pollution for purposes of the exclusion." Third, the court examined a "Dampness or Temperature" Exclusion and held that it did not apply because the insurers did not allege any dampness, water vapor, or temperature extremes. However, the court held that the Faulty Materials exclusion applied because even though the drywall served its purposes of a "room divider, wall anchor, and insulator," the fact that the insureds claimed that the emissions rendered the homes "unlivable" by definition meant that the drywall was faulty. Last, the court held that the Corrosion Exclusion applied because the term "corrosion" includes the "action, process, or effect of corroding."

The recent outlier, Ross v. C. Adams Construction & Design,[8] flying in the face of prior Louisiana cases — including one from the state's highest court — found for the insurer. In *Ross*, the Fifth Circuit Court of Appeal of Louisiana changed course from Finger, Doerr, and In re: Chinese Drywall in its interpretation of the Pollution Exclusion. The Ross court held that the Pollution Exclusion applied because the exclusion listed "any gaseous irritant or contaminant, including vapors, fumes, and chemicals." The court concluded that the gaseous odors qualified as pollutants pursuant to the exclusion's language, but did not expressly distinguish its reasoning from the earlier Louisiana decisions in Doerr, Finger, and In re Chinese Drywall, all of which held otherwise. Regarding the other exclusions, the Ross court reasoned that the plain language of the Faulty Materials Exclusion barred coverage for the Chinese drywall, which was defective notwithstanding the fact that it may have served its intended purpose. The court also held that the Latent Defect Exclusion applied because the homeowners did not know about the defective drywall for two years, and a customary inspection would not have revealed it during that time.

III. What To Do?

With the true scope of the Chinese drywall problem as yet unknown, and with case law leaning toward insurers but by no means settled, carriers, brokers and TPAs — and their counsel — are left wondering how to proceed.

Regarding litigation already in the pipeline, insurers' settlement postures ought to depend heavily on the case law — limited though it may be — in the jurisdictions in which they write policies, allowing, of course, for differences in fact patterns across cases. In Mississippi and Virginia, for instance, that would tend to mean insurers forcing insureds to make their cases and taking a hard line on negotiated resolutions. In unsettled Louisiana, perhaps a wait-and-see approach might be wise, as we see whether *Doerr* will govern and *Ross* was an aberration — and one that might be overturned — or *Ross* is upheld and signals a shift in that state's coverage jurisprudence. We would generally advise a similar posture in Florida, where the landscape is similarly unsettled due to the absence of first party case law and the relative paucity of any on-point third party cases.

Regarding future policies, the carriers might consider specific exclusions for drywall emissions. It is unclear whether the various states' departments of insurance will allow such changes to standard forms; that might be fodder for creative government relations and lobbying endeavors. It is even less clear whether the various jurisdictions' courts would honor those specific exclusions. At the very least, however, specific exclusions might create a scenario where insurers have created favorable settlement landscapes when the inevitable lawsuits are filed.

Endnotes

1. 715 F. Supp. 2d 699 (E.D. Va. 2010).

2. 2011 U.S. Dist. LEXIS 55282 (E.D. Va., May 13, 2011).

3. 2011 U.S. Dist. LEXIS 64149 (S.D. Miss. June 16, 2011).

4. 2011 U.S. Dist. LEXIS 63948 (S.D. Miss. June 17, 2011).

5. 2011 U.S. Dist. LEXIS 52837 (M.D. Fla., May 17, 2011).

6. 2010 WL 1222273 (La. Dist. Ct. 2010).

7. 2010 U.S. Dist. LEXIS 133497 (E.D. La., Dec. 16, 2010).

8. 2011 La. App. LEXIS 769 (5th Cir. La., June 14, 2011). ■

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1600 John F. Kennedy Blvd., Suite 1655, Philadelphia, PA 19103, USA
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