

**INSURANCE COVERAGE FOR CHINESE DRYWALL
EXPOSURES**

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INSURANCE COVERAGE FOR CHINESE DRYWALL EXPOSURES

I. HISTORY AND RESULTING LITIGATION

Due to the scarcity of building supplies from 2004 to 2008 in the wake of the national housing boom and the aftermath of several hurricanes pummeling the eastern and southern coasts of the United States, some builders began importing drywall from China and elsewhere.¹ After installation, some owners of homes containing the Chinese drywall complained of adverse health effects including headaches, dry cough, eye and sinus irritation, rashes, asthma, irritated throat, respiratory infections, bronchitis, fatigue and nosebleeds. They also noticed a “rotten egg” smell emanating from the drywall, together with corrosion and damage to copper wiring, HVAC coils, computers, televisions, appliances and other metals in their homes. The cost of identifying, tearing out and replacing the drywall, as well as repairing other property damage, is exceedingly high, let alone the damage related to loss of use and diminution in value of the affected home.

Not surprisingly, insurance claims relating to Chinese drywall have increased, both first party claims by owners against their own property insurers, and third party claims implicating the liability insurers of contractors, drywall subcontractors, manufacturers and suppliers of the defective drywall. Denials of claims by some insurers are leading to coverage litigation but since litigation surrounding the claims is in its early stages, there is very little definitive guidance from the courts regarding whether these claims are covered by insurance.

In an early case involving Chinese drywall, Lennar Corporation filed suit in Florida in January 2009 against Chinese drywall manufacturer Knauf Plasterboard Tianjin Company, USG Corporation and twelve drywall installers in *Lennar Homes LLC v. Knauf Gips KG, et al.*, Case No. 09-07901CA23, 11th Judicial Cir. Miami Dade Co., Florida, filed January 30, 2009. That same day, two Florida homeowners on behalf of themselves and a class of Florida homeowners, filed suit against various drywall manufactures, homebuilders and building supply companies in Florida in *Allen, et al v. Knauf Plasterboard Tianjin, et al*, Case No. 2:09-CV-54-FtM-99 DNF, U.S. Dist. Ct. Middle Dist. of Fla., Fort Myers Div., filed January 30, 2009. Further, in March 2009, owners of a Florida home filed a complaint on their homeowners policy for damages due to the

Chinese drywall in their home in *Keith Baker and Linda Leri v. American Home Assurance Company, Inc.*, Case No. 09-CV-188, M.D. Fla. Baker and Leri alleged that the drywall damaged their property and interfered with their use and enjoyment of their home.

In Wake County, North Carolina, other homeowners sued their homebuilder – but not the drywall subcontractor or manufacturer – in *Flannigan v. Stafford Custom Homes, Inc.* File No. 09CV006759, Wake County Superior Court, asserting claims for breach of contract, breach of express and implied warranties, deceptive trade practices, and negligence.

In a traditional coverage suit, *Builders Mutual Insurance Company v. Dragas Management Corporation, et al*, Case No. 2:09-cv-185, E.D. Va., filed Apr. 23, 2009, Builders Mutual filed suit against the insured builder, Dragas Management Corporation, as well as Firemen’s Insurance Company and The Hanover Insurance Company in a federal declaratory relief action in Virginia. Builders Mutual seeks a judicial declaration that coverage for Chinese drywall claims against Dragas is barred by the “business risk” exclusions and the total pollution exclusion in its policies issued to Dragas. In particular, Builders Mutual relies on the Total Pollution Exclusion and the Your Work Exclusion, contending that the homeowner complaints of rotten egg smells in their houses, corrosion-related air conditioning failures, failures of televisions and microwaves, and health-related complaints including headaches, rashes, watery eyes, sinus congestion, apnea, coughing, sore throats and fatigue, are due to “off-gassing” from the Chinese drywall of sulfur compounds, including carbon disulfide and carbonyl sulfide. The insurer contends that the pollution exclusion “unambiguously” excludes the Chinese drywall claims because “[t]he off-gassing of the sulfur compounds from the Chinese drywall clearly constitutes the ‘actual, alleged or threatened discharge, dispersal, seepage, migration, release or escape of pollutants at any time,’ and the compounds, which are known to be contaminants and irritants, clearly come within the definition of pollutants as ‘any solid, liquid, gaseous, or thermal irritant or contaminant including smoke, vapor, soot, fumes, alkalis, chemicals and waste.’” In response, Dragas asserted counterclaims for breach of the implied covenant of good faith and fair dealing, and bad faith claims investigation.

Moreover, on January 13, 2010, the attorney general of Louisiana, Buddy Caldwell, filed suit in Orleans Parish Civil District Court against nine foreign drywall manufacturers, eleven drywall supply and distribution companies, and three home builders involved with Chinese drywall. The Louisiana AG alleges that manufacturers should have known that the

¹Although these claims have come to be known as “Chinese drywall” claims, it now has been acknowledged by the CDC that the defective drywall did not originate entirely from China and that not all Chinese drywall may be defective.

Chinese drywall would be harmful, and alleges conspiracy throughout the building industry to profit from the reckless use of the imported drywall. This lawsuit is the first Chinese drywall lawsuit brought by an attorney general.

The largest concentration of homeowner suits is found in Multidistrict Litigation No. 2047 (the "MDL"), pending in the United States District Court for the Eastern District of Louisiana, where the United States Judicial Panel on Multidistrict Litigation originally consolidated ten lawsuits from three states in June 2009. The Panel's consolidation order found that the cases "share factual questions concerning drywall manufactured in China, imported to and distributed in the United States, and used in the construction of houses; plaintiffs in all actions allege that the drywall emits smelly, corrosive gases." As of September 1, 2009, there were over 150 lawsuits in the MDL. It is unclear whether federal insurance coverage lawsuits will be transferred to the MDL. Updates and orders relating to the MDL can be found at <http://www.laed.uscourts.gov/drywall/drywall.htm>.

These cases are representative of the burgeoning litigation springing up across the country as a result of the damages to homeowners who allege they can no longer reside in their homes and cannot afford the remediation costs.

At this time, it appears as though there may be no viable method of addressing the property damage and bodily injury resulting from the Chinese drywall other than completely tearing out and replacing the defective drywall. Some builders, including Ryland Homes and Lennar Homes, have begun to do so. Lennar Homes disclosed in its SEC 10-K filing that as of November 30, 2009, it had reserved \$58 million for warranty costs related to defective drywall manufactured in China that was purchased and installed by various of its subcontractors. This number is up from the just under \$40 million reserve Lennar included in its previous filing for approximately 400 homes constructed with Chinese drywall in Florida, reflecting Lennar's apparent estimated repair costs of almost \$100,000 per home.

II. REGULATORY INVESTIGATION

The U.S. Consumer Product Safety Commission ("CPSC") leads the "Federal Drywall Team" comprised of the CPSC, the Environmental Protection Agency, the Agency for Toxic Substances and Disease Registry, and Centers for Disease Control and Prevention. In July 2009, the CPSC issued a preliminary report outlining its investigation into the drywall problem. CPSC is also working closely with state and local health departments. CPSC studies included a 51 home study, chamber studies, elemental

analysis, and engineering analyses to study the effects of the drywall on various equipment in the home to assess the risk of possible fire and shock hazards. A September 2009 CDC report sets forth a guideline for healthcare providers outlining the health complaints and the potential causal link between those complaints and sulfur gas emissions, although the CDC readily admits in that report that as of September 2009 "not enough information exists to determine the nature and magnitude of a potential health risk."

In its September 2009 status report, the CPSC indicated it had confirmed that nearly 7 million sheets of Chinese drywall were imported into the United States. The latest CPSC update from February 2010 reflects that the CPSC has received 2941 drywall complaints from 37 states, the District of Columbia and Puerto Rico. According to that update, 90% of the claims have come from Florida (59%), Louisiana (21%), Mississippi (6%), Alabama (5%), and Virginia (4%). Although not in those top five, claims have also originated from Texas. The CPSC further has identified stockpiled Chinese drywall and has notified the owners of the warehouses storing such drywall that it is not to be used. The CPSC also is working with the Department of Homeland Security to ensure that there are no more imports of the affected drywall, and it reports that the Chinese government is cooperating in the technical part of the investigation. *See* 10-29-09/10:00 a.m. CPSC Media Conference Call, Confirmation # 9800108.

The CPSC issued a January 28, 2010 publication providing a two-step Guidance to identify the presence of problem drywall in homes. That Guidance requires both a visual inspection showing blackening of copper electrical wire and/or air conditioning evaporator coils, plus the installation of new drywall between 2001 and 2008. Homes with new drywall installed between 2005 and 2008 must also meet at least two additional criteria relating to the chemical analysis of the metal corrosion, elemental markers in the drywall, markings on the drywall, or specific chemical emissions from the drywall. Homes with new drywall installed between 2001 and 2004 must meet at least four of the listed criteria.

Studies by ENVIRON, an environmental consulting firm that submitted a report to the Florida Department of Health, indicate that it had detected elemental sulfur in Chinese drywall at concentrations that were 20 times higher than those in domestically produced drywall. EPA chemical studies on the drywall confirm that there are significant differences between domestic drywall and the defective Chinese drywall, including a statistically significant higher concentration of strontium and elemental sulfur. *See*

August 27, 2009 and September 16, 2009 Memoranda issued by the Environmental Protection Agency.

On October 29, 2009, the CPSC issued its draft Staff Preliminary Evaluation of Drywall Chamber Test Results, confirming findings of higher total volatile sulfur compound emissions from the defective drywall. The current CPSC emphasis, according to its latest February 2010 update, appears to be focused on the effect of the corrosion from the drywall and whether that corrosion may result in increased risk of fire hazards. It also is focused on identifying possible remediation plans.

III. THE LEGISLATIVE RESPONSE

Chinese drywall has spawned a variety of proposed legislation to address the problem. On March 30, 2009, two senators from Florida and Louisiana introduced the Drywall Safety Act of 2009 (S. 739), in part to require CPSC to study Chinese drywall from 2004 to 2007 and to determine whether drywall regulations are necessary to protect residential homeowners. The proposed legislation would require a recall of Chinese-made drywall and a temporary ban on imports until federal drywall safety standards are put in place to protect consumers. A companion bill was introduced in the House (H.R. 1977) on April 2, 2009. Both bills are still in committee.

The Mortgage Reform and Anti-Predatory Lending Act Mortgage Reform and Anti-Predatory Lending Act (H.R. 1728) passed in the House on May 7, 2009 by a vote of 300-114. That legislation would require examination of the availability of insurance to homeowners of contaminated homes. The bill has not yet been put to a Senate vote.

Similarly, the Drywall Victims Insurance Protection Act of 2009 (H.R. 4094) was introduced in the House on November 17, 2009, seeking to prohibit insurers from canceling or refusing to renew homeowners insurance policies because of the presence of certain types of drywall in the home, because those homeowners often find themselves dropped by their insurers after filing claims and unable to obtain new insurance as a result of not repairing the defects.

The Foreign Manufacturers Legal Accountability Act of 2009 (S. 1606) was introduced in the Senate on August 6, 2009. A companion bill with the same name but “of 2010” was introduced in the House (H.R. 4678) on February 24, 2010 as a result of concerns about obtaining personal jurisdiction over foreign defendants, particularly in the MDL. If passed, the legislation would make it easier to bring a foreign company before U.S. courts by requiring it to keep a registered agent in at least one state where it does significant business who can be served with a lawsuit. It further would require

the foreign company to agree to be held accountable by U.S. courts if sued here. Both the Senate and House bills are still in committee.

On December 8, 2009, the Chinese Drywall Homeowners Assistance Act (S. 2850) was introduced in the Senate that would permit the use of federal funds from the Community Development Block Grant Program to be used to remediate damage from the installation of tainted drywall.

On November 10, 2009, Senate Resolution 352 passed, encouraging banks and mortgage servicers to work with families affected by contaminated drywall and to consider adjustments to payment schedules on their home mortgages that take into account the financial burdens of responding to the presence of such drywall. On December 7, 2009, the House passed the similar House Congressional Resolution 197.

In terms of state efforts, Louisiana and Mississippi already have in place New Home Warranty Acts that provide prescribed warranty periods for different home components for the benefit of the purchaser of the home, as well as successors or assigns. It is unclear whether these Acts will provide causes of action against builders in those states, as they do not appear to have been interpreted in conjunction with the Chinese drywall claims.

IV. FIRST PARTY CLAIMS

In response to the damage to their homes, some homeowners are filing first party claims against their homeowners insurance policies for Chinese drywall damages. They seek coverage for their bodily injuries and property damage, including damages related to the diminution in value and loss of use of their homes. Likewise, commercial property owners are seeking coverage under commercial property policies. As with any coverage question, a first party claim is governed by the terms of the insurance agreement between the insurer and the insured. The insured has the initial burden of demonstrating that a claim potentially is within the scope of coverage, but the burden then shifts to an insurer to prove that one of the exclusions, conditions, and/or limitations within the policy constitutes an avoidance or affirmative defense that defeats coverage in its entirety. In particular, Chapter 554.002 of the Texas Insurance Code makes clear that the insurers must plead and prove, by a preponderance of the evidence, that an exclusion or other affirmative defense negates coverage.

A. The Insuring Agreement - “Direct Physical Loss”

In analyzing whether coverage exists under a property insurance policy for damage to a residence or other building caused by defective drywall, the initial

issue is whether such damage constitutes a “direct physical loss” as required by the insuring agreement. Incorporation of defective materials into the home during the homebuilding process may not constitute direct physical loss under the limited available case law on the issue. For example, in *Trinity Indus. Inc. v. Ins. Co. of North America*, 916 F.2d 267, 270-271 (5th Cir. 1990), the Fifth Circuit held that “[t]he language ‘physical loss or damage’ strongly implies that there was an initial satisfactory state that was changed by some external event into an unsatisfactory state - for example, the car was undamaged before the collision dented the bumper. It would not ordinarily be thought to encompass faulty initial construction.” *Id.* The court specifically distinguished coverage for an accident caused by defective workmanship from the cost of replacing or repairing the defective workmanship itself. *Id.*

The physical loss requirement “is widely held to exclude losses that are intangible ... [and precludes] any claim ... when the insured merely suffers a detrimental economic impact unaccompanied by a distinct, demonstrable, physical alteration of the property.” *De Laurentis v. United Services Auto. Ass'n*, 162 S.W.3d 714, 723-24 (Tex.App.—Houston [14th Dist.] 2005, pet. denied). Thus, damages for loss of enjoyment, loss of use and the like probably do not come within the insuring agreement. But, the rotten egg smell permeating the homes from the defective drywall may qualify as a covered damage since odor itself may constitute a physical injury. *See Essex, Inc. Co. v. BloomSouth Flooring Corp.*, 562 F.3d 399, 407-09 (1st Cir. 2009) (concluding that allegations of damage from carpet odor were a claim of physical injury). Nevertheless, the corrosion damage resulting from the sulfur compound emissions from Chinese drywall may constitute “direct physical loss,” both to the electrical and HVAC systems in the home, as well as the wiring and personal property such as appliances and electronics. The systems were initially in an undamaged state, but due to exposure to the emissions from the drywall, they were changed to an unsatisfactory and damaged state under Texas law. *Trinity Industries v. Insurance Co. of North America, supra.*

B. Property Exclusions

Exclusions found in all risk property policies must be construed narrowly and in favor of the insured. *Blaylock v. Am. Guar. Bank Liab. Ins. Co.*, 632 S.W.2d 719, 721 (Tex.1982); *Glover v. Nat'l Ins. Underwriters*, 545 S.W.2d 755, 761 (Tex.1977). This rule does not abrogate the overriding principles of construction, however, that unambiguous words and phrases in the policy exclusions must be given their

ordinary meaning unless a contrary intention is indicated by the policy terms.

1. Pollution Exclusion

Because the damages from the contaminated drywall appear to stem from the noxious off-gasses emanating from the drywall, they implicate the standard pollution/contamination exclusion found in many homeowners forms. For example, one homeowners form provides that the insurer will not insure loss caused by:

- (e) Discharge, dispersal, seepage, migration, release or escape of pollutants unless the discharge, dispersal, seepage, migration, release or escape is itself caused by a Peril Insured Against named under Coverage C.

Pollutants means any 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.²

In contrast, other homeowners forms simply exclude loss caused by “contamination.” See Texas Homeowners Policy-Form B.

The U.S. Environmental Protection Agency specifically lists carbon disulfide, one of the components found in the defective drywall, as a “hazardous air pollutant.” See 40 C.F.R. § 63.5480 and 40 C.F.R. Pt. 63, Subpt. HH, App. As noted by the Dallas Court of Appeals, “[c]ontamination occurs when a condition of impairment or impurity results from mixture or contact with a foreign substance.” *Auten v. Employers Nat. Ins. Co.*, 722 S.W.2d 468, 469 (Tex.App.—Dallas 1986, writ denied), citing *American Casualty Co. of Reading, Pennsylvania v. Myrick*, 304 F.2d 179, 183 (5th Cir. 1962); e.g., *American Produce & Vegetable Co. v. Phoenix Assurance Co. of New York*, 408 S.W.2d 954, 955-56 (Tex.Civ.App.—Dallas 1966, no writ) (when ammonia gas escaped from refrigeration system causing foodstuffs to be unfit for human consumption, the court held that the loss was not covered because of contamination exclusion). And, if the cause of the injury is listed within the exclusion, it will trigger application of the exclusion. *See Lexington Ins. Co. v. Unity/Waterford-Fair Oaks, Ltd.*, 2002 WL 356756 (N.D.Tex. 2002) (holding that because the policy expressly included “fungi” within

² ISO Homeowners 3-special form, HO 00 03 05 01.

the list of contaminants or pollutants, the exclusion applied to mold claim); *Am. States Ins. Co. v. Nethery*, 79 F.3d 473, 476 (5th Cir.1996) (holding that, regardless whether paint fumes would typically fall within definition of “pollutant,” inclusion of term “fumes” in pollution exclusion clause mandated exclusion of claim based on inhalation of paint fumes).

The negligence of the builder or installer in incorporating the defective drywall into the structure will not save coverage in Texas. For example, in *Auten v. Employers*, the court rejected the homeowner’s contention that coverage should exist because negligence was not an excluded peril and the negligence of the exterminator in spraying pesticide caused the contamination, in other words the contamination would not have occurred absent the negligence. In doing so, the court recognized that “[i]t appears well-settled that, in Texas, recovery would not be permitted if either event constituted an excluded peril.” 722 S.W.2d at 470 n.1.

As these cases indicate, Texas law as to the applicability of the pollution exclusion is fairly well developed, particularly in the CGL policy context. That law is more fully described in the accompanying paper of the co-presenter on this panel. Nevertheless, based on *National Union Fire Ins. Co. v. CBI Industries, Inc.*, 907 S.W.2d 517 (Tex. 1995), Texas is usually regarded as a state that will enforce a clear and unambiguous pollution exclusion. Moreover, under Texas law, the exclusion is not limited to only those discharges causing environmental harm, but also to indoor discharges. See *Amoco Production Co. v. Hydroblast Corp.*, 90 F.Supp. 2d 727 (N.D. Tex. 1999); *Nautilus Ins. Co. v. Country Oaks Apartments*, 566 F.3d 452 (5th Cir. 2009) (applying exclusion to deny coverage for injuries due to exposure to carbon monoxide due to a blocked vent in an apartment). Based on these cases, where the homeowners policy contains a pollution exclusion that applies to discharges, dispersals or releases of substances that qualify as pollutants under the exclusion, even in an indoor atmosphere, coverage may be excluded.³ For this reason, accordingly, the sulfuric off-gasses from the drywall likely may place the insured’s damages within pollution exclusions of many property policies, under Texas law, unless another cause of the damage is found upon further defective drywall investigations.

2. Inherent Vice

The proliferation of drywall claims in the southern states may be partly a result of the high humidity and moisture in those states that exacerbates the drywall’s hazardous emissions and the damages caused thereby.

Accord, the CDC’s “Imported Drywall and Health – A Guide for Healthcare Providers” (September 2009) (“because warm and humid conditions may cause or emissions from drywall, we do not yet know whether opening windows to allow fresh air to come into the home is beneficial”). If this is shown to be the case, insurers may argue that first party insurance claims pertaining to Chinese drywall are precluded.

Despite the fact that the humidity or dampness present in the home may trigger the chemical reaction within the Chinese drywall and the off-gassing of the harmful fumes, insurers may raise the inherent vice exclusion that generally states that the property insurance will not apply to damage caused by “[m]echanical breakdown, latent defect, inherent vice, or any quality in property that causes it to damage or destroy itself.” See, e.g., *Crocker v. American Nat. General Ins. Co.*, 211 S.W.3d 928 (Tex.App.—Dallas 2007, no writ). For example, in *Employers Casualty Co. v. Holm*, 393 S.W.2d 363, 366-67 (Tex.Civ.App.—Houston 1965, no writ), the court held that the failure to install a shower pan in the home was an “inherent vice” where that failure caused water damage to the home. Nevertheless, inherent vice generally relates to a loss resulting entirely from internal decomposition or some quality that brings about the property’s own injury or destruction. The vice must be inherent in the property for which recovery is sought. *Id.* Against this background, although the claims relate to the internal composition of the drywall itself, the Chinese drywall apparently off-gasses when exposed to high humidity. Under those circumstances, it is possible that the “vice” may not be “inherent” so as to invoke the exclusion.

3. Corrosion Exclusion

Many property policies, both commercial and personal, including homeowners policies, may include an exclusion that is usually coupled with the inherent vice exclusion that denies coverage for loss caused by “corrosion.” Oftentimes, the term corrosion is not defined, but its grouping with the inherent vice exclusion and the wear and tear exclusion usually indicates an intent to provide property insurance for fortuitous losses, i.e. where the corrosion is not inevitable and is the product of exterior forces rather than natural aging. See *Hampton Foods, Inc. v. Aetna Casualty & Surety Co.*, 787 F.2d 349 (8th Cir. 1986) (applying Missouri law). In other words, where the damage was caused by the application of some external force, such as fire, wind or snowstorm, the exclusion will not apply. See *United Technologies v. American Home Assurance Co.*, 989 F.Supp. 128 (D. Conn. 1997); Peter J. Kalis & James R. Segerdeo, *Policy-Holders Guide to Insurance Coverage*, §13.07 [B][5].

³ See Section V.A below.

Here, the corrosion of the electrical wiring, switches, HVAC, appliances, etc. due to exposure to the off-gassing of the Chinese drywall is due to an external force, that is the sulfur compounds. As such, it appears that a corrosion exclusion will likely not apply.

4. Dampness of Atmosphere

Homeowners and commercial property policies may include an exclusion for loss caused by “dampness of atmosphere,” again, contained in the same grouping of exclusions as inherent vice, corrosion and wear and tear.

As previously noted, despite the widespread use of Chinese drywall, the problem appears most prevalent in regions where there are high levels of humidity, such as along the Gulf Coast. The increased moisture in these areas tends to increase the sulfur off-gassing more quickly than in areas where the air is dryer. As a result, insurers may argue that the exclusion for loss caused by “dampness of atmosphere” applies because the dampness of the atmosphere causes the Chinese drywall to emit the sulfur compounds that result in damage.

Insurers have experienced some success with this argument in cases involving mold growth. For example, in *Aetna Casualty & Surety Co. v. Yates*, 344 F.2d 939 (5th Cir. 1965), the court held that rotting damage to the homeowners’ joists, sills and subflooring, caused by an inadequate supply of vents in the crawl space under the house, was barred under the exclusion for loss caused by dampness of atmosphere. In particular, the court found that the contact between air trapped in the crawl space and the subfloors and sills, which had been chilled by air conditioning, produced condensation of moisture and consequent rotting. However, it appears that such an argument for the application of this exclusion would be more difficult as to Chinese drywall where the dampness of the atmosphere is not the result of an abnormal circumstance, but rather, an ordinary and expected weather condition in certain geographical locations.

V. THIRD-PARTY CLAIMS

Chinese drywall has resulted in claims and lawsuits against developers, builders, contractors, manufacturers, subcontractors and suppliers/distributors, resulting in numerous claims being filed, in turn, with CGL insurers by insureds seeking defense and indemnification for alleged damages resulting from installation and sale of the product. Due to the nature of the allegations, particularly against participants in the construction industry, these claims are likely to involve allegations of defective workmanship. Nowhere is the distinction between first party property coverage and liability

coverage more blurred than in the area of defective work. Defective work exposures often dovetail with the insured’s so-called “business risks,” that is, those risks that are apparently under the control of the insured and that sometimes, rightly or wrongly, are not regarded as fortuitous in nature. Understandably, insurers are hesitant to insure these types of risks, but it is often extremely difficult to distinguish between uninsurable business risks and accidental property damage covered under a CGL policy.

Since property damage arising out of Chinese drywall claims will implicate defective workmanship and manufacture, many of the typical construction defect issues will arise, i.e. the legal obligation of the insured contractor to make repairs, whether there is an occurrence, whether there is property damage, and the applicability of various exclusions, including the your work, your product, impaired property, and the product recall exclusions. These issues are addressed in the companion paper presented as part of this panel and will not be reiterated here.

Nevertheless, aside from the installation and manufacturing construction defect issues, Chinese drywall presents unique issues relating to the pollution exclusion, some of which were discussed above in connection with first party property coverage. These issues may be somewhat akin to issues addressed as to insurance coverage for mold under liability policies prior to the advent of mold exclusionary endorsements. Moreover, similarities between the allegedly toxic properties of Chinese drywall also mirror those associated with other dangerous substances, including asbestos, lead and silica, all of which are also the subject of separate exclusionary endorsements in the CGL policy. Since the onslaught of Chinese drywall claims is relatively new, it does not appear that separate exclusionary endorsements for bodily injury and property damage arising out of Chinese drywall have yet been developed. Depending on the eventual scope of the problem and the lingering nature of the claims, it is likely that such endorsements are on the horizon. Until then, the pollution exclusion will likely remain a primary vehicle relied upon by insurers to deny Chinese drywall claims.

A. Pollution Exclusions

Exclusion f has been maintained with some revisions in the ISO CGL policy form since 1986, and is perhaps the most familiar pollution exclusion. However, from the insurance industry’s point of view, and particularly with regard to such industries as construction, that exclusion, often mistakenly referred to as the “Absolute Pollution Exclusion,” is subject to several gaps. The major gap is that it does not apply to the products-completed operations hazard. As to other

exceptions, *see Kelley-Coppedge, Inc. v. Highlands Ins. Co.*, 980 S.W.2d 462 (Tex. 1998), observing that coverage is available under the exclusion in certain instances, including off-site pollution releases where the contractor encounters existing pollutants on the job site, under the equivalent of the current subparagraph (1)(d) of Exclusion f.

These gaps in the exclusion led to the introduction of the Total Pollution Exclusion by endorsement. That endorsement replaces the standard pollution exclusion, Exclusion f, in the CGL policy form. The standard ISO form that accomplishes this intent is CG 21 49, stating that the insurance does not apply to:

f. Pollution

- (1) “Bodily injury” or “property damage” which would not have occurred in whole or part but for the actual, alleged or threatened discharge, dispersal, seepage, migration, release or escape of “pollutants” at any time.
- (2) Any loss, cost or expense arising out of any:
 - (a) Request, demand or order that any insured or others test for, monitor, clean up, remove, contain, treat, detoxify or neutralize, or in any way respond to, or assess the effects of “pollutants”; or
 - (b) Claim or suit by or on behalf of a governmental authority for damages because of testing for, monitoring, cleaning up, removing, containing, treating, detoxifying or neutralizing, or in any way responding to, or assessing the effects of “pollutants”.

The definition of “pollutants” is retained and is utilized in the endorsement:

“Pollutants” mean any solid, liquid, gaseous, or thermal irritant or contaminant including smoke, vapor, soot, fumes, acid alkalis, chemicals and waste. Waste includes material to be recycled, reconditioned or reclaimed.

This exclusion is considerably broader in scope than the 1986 pollution exclusion, largely because it applies in the products-completed operations context. In addition, it also excludes coverage for releases of pollutants that were not brought onsite by the insured

contractor. *See Kelley-Coppedge v. Highlands*, 980 S.W.2d 462, 467 (Tex. 1998). There are many endorsements, particularly in excess and surplus lines policies issued to insureds, that are similar in scope.

For example, in *Lexington Ins. Co. v. Unity/Waterford-Fair Oaks, Ltd.*, 2002 WL 356756 (N.D. Tex. March 5, 2002), the pollution exclusion before the court defined the term “contaminants or pollutants” as “including, but not limited to, bacteria, fungi, viruses or hazardous substances as listed in the Federal Water, Pollution Control Act, Clean Air Act, Resource Conservation and Recovery Act of 1976, and Toxic Substances Control Act or as designated by the U.S. Environmental Protection Agency. Waste includes materials to be recycled, reconditioned or reclaimed.” The court applied this exclusion in the commercial property policy before it to deny coverage for mold damage to first and second floor units of an apartment building arising out of roof leaks. Since there was no specific reference to mold, fungi, etc. within the pollution exclusion, the court held that the exclusion should not be applied. The standard 1973 and 1986 pollution exclusions contain no such specific reference to mold, fungi or other organisms.

Beginning with *National Union v. CBI Industries*, more fully discussed in Section B.1 above, Texas courts have applied the plain and unambiguous terms of such exclusions to deny coverage to insureds, even for indoor emissions, or other exposures not traditionally associated with environmental pollution in accord with the intent of those endorsements. In that connection, see the discussion set out in the companion paper on coverage for Chinese drywall under CGL policies. For a recent case exhibiting the enforceability of broad pollution exclusions under Texas law, *see Noble Energy, Inc. v. Bituminous Cas. Co.*, 529 F.3d 642 (5th Cir. 2008), where a liability insurer relied on its standard pollution exclusion to deny coverage for a truck explosion allegedly caused by vapors emanating from items placed in the truck. Rejecting the claimant’s argument that the pollution exclusion is limited to claims for pollution released into the environment, the court held that “a 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*, 529 F.3d at 649.

In light of the CPSC’s Home Study investigation, in which it found increased levels of hydrogen sulfide levels in the homes with the defective drywall, and a “strong association” between those levels and corrosion in the homes, the sulfur compounds or other toxins emitted from the drywall may be considered “pollutants.” *See Admiral Ins. Co. v. Feit Management*

Co., 321 F.3d 1326, 1330 (11th Cir. 2003) (exception to pollution exclusion for fumes from equipment used to heat a building did not apply to preserve coverage for claims of death and injury where carbon monoxide fumes from an improperly vented water heater flowed through HVAC system into apartments of victims); *Technical Coating Applicators, Inc. v. U.S. Fidelity Guaranty Co.*, 157 F.3d 843, 846 (11th Cir. 1998) (pollution exclusion applied to bar coverage for suits filed by claimants injured by breathing vapors emitted by roofing products used by insured, regardless of whether the products were used properly or negligently); *Reed v. Auto-Owners Ins. Co.*, 667 S.E.2d 90, 92 (Ga. 2008) (holding that carbon monoxide was a pollutant under the exclusionary clause as the claimant alleged that she was “poisoned” by the carbon monoxide, causing her bodily injury); *Deni Associates of Florida, Inc. v. State Farm Fire & Cas. Ins. Co.*, 711 So.2d 1135, 1138 (Fla. 1998) (holding that ammonia spilled from a blueprint machine causing indoor contamination in an office and insecticide accidentally sprayed on bystanders were both pollutants under the CLG absolute pollution exclusion, rejecting traditional pollution limitation argument); *but see, Meridian Mutual Ins. Co.*, 197 F.3d 1178, 1185 (6th Cir. 1999) (holding that pollution exclusion does not apply where claimant alleged suffered respiratory injury from fumes insured used to seal a floor on adjacent room, even where the parties agreed the sealer was a pollutant, because the movement of fumes from toxic chemical was localized and therefore did not satisfy requirement that injury result from discharge, dispersal, seepage, migration, release or escape of pollutants”).

Nevertheless, it should be noted that the applicability of a pollution exclusion to the types of indoor emission associated with Chinese drywall, like many insurance coverage issues, is a creature of state law. In other words, some jurisdictions have limited the scope of pollution exclusions to traditional environmental pollution, the context in which they were originally intended to apply. For example, *see Doerr v. Mobil Oil Corp.*, 774 So.2d 119 (La. 2000) (pollution exclusions are intended to exclude coverage for active industrial polluters where businesses knowingly emitted pollutants over extended periods of time); *Stoney Run Co. v. Prudential LMI Commercial Ins. Co.*, 47 F.3d 34 (2d Cir. (N.Y.) 1995) (pollution exclusions are to be construed in light of their general purpose, which is to exclude coverage for environmental pollution). Therefore, in some states, this narrow interpretation of the scope and purpose of a pollution exclusion may affect its applicability to Chinese drywall claims.

As the investigation into the causes of the Chinese drywall damage continues, the application of the

pollution exclusion and the insurers’ duty to indemnify likely will turn on the actual scientific causes that ultimately are determined to have caused the injuries.

B. Contractors Pollution and Pollution Legal Liability Policies

As result of the exclusion of environmental and workplace releases of pollutants under the CGL, and in the face of increasing regulation of jobsite or post-completion releases, insurers responded by tailoring specific types of insurance coverages. Those products are intended to fill the coverage gaps created by the pollution exclusion in the CGL policy. These products include pollution legal liability (PLL) and contractors pollution liability (CPL) policies. The markets for these products have steadily increased in the last 10 to 12 years for obvious reasons.

PLL policies are written for a variety of businesses, the operations of which give rise to environmental exposures, including industrial owners, developers, environmental professionals and others. At the same time, the CPL policy provides coverage more tailored to the needs of the construction industry. Due to the likelihood that Chinese drywall off-gassing and emissions, together with the associated odor, corrosion and other property damage may implicate the pollution exclusion, it would appear that CPL and PLL policies may serve their traditional function in this context, that is, filling the gap in coverage created by application of a pollution exclusion to Chinese drywall claims. Similar considerations may render specialized pollution policies as the vehicle by which the construction industry will address Chinese drywall exposures. Moreover, it appears the Chinese drywall exposures more readily fall within standard definitions of “pollution conditions,” “pollution events” or “pollutants” found in those policies because Chinese drywall does not appear to involve an organic component, mold or fungi. At the same time, in the event it is eventually determined that Chinese drywall has its own set of unique characteristics, it could be anticipated that CPL and PLL policies could be endorsed to specifically provide such coverage.

The scope of coverage can vary widely from one form of CPL policy to another. Policy forms are not standardized and there is room for negotiation based upon the characteristics of the individual risk. In general, a CPL policy is intended to provide coverage for bodily injury, property damage, and clean-up at a job site. Most of these forms are designed to apply only to liabilities arising out of the contractor’s operations; however, coverage for damages associated with pollution emanating from the contractor’s premises and damage to the contractor’s own property is available by endorsement. Most claims are subject

to a deductible and coverage is usually provided on a claims made basis, though occurrence-based coverage may be available.

CPL insuring agreements are drafted so as to be triggered by a claim or loss involving “pollution conditions” or a “pollution event,” or some similar formulation, that takes place during the policy period and for which claim is made during the policy period if the policy is written on a claims made basis. The terms “pollution conditions” or “pollution event” are defined as “the discharge, dispersal, release, or escape of any solid, liquid, gaseous or thermal irritant, contaminant or pollutant including smoke, vapor, soot, fumes, acids, alkalis, chemicals and waste,” or “the discharge, dispersal, release, or escape of pollutants.”

Moreover, as previously stated, CPL policies are generally designed to pick up coverage at the point where a CGL policy’s pollution exclusion cuts off coverage. Therefore, the definition of “pollutants” is usually similar to the following: any solid, liquid, gaseous or thermal irritant or contaminant, including smoke, vapor, soot, fumes, acids, alkalis, chemicals and waste. Thus, that definition sets out the type of releases of pollutants that are covered under the CPL policy, and they are the same type of releases of substances that are excluded under the CGL policy.

CPL policies also include exclusions, many of which are similar to those commonly found in CGL policies. The policies usually contain work and product exclusions that may operate where the damage is to the work of the insured itself. These exclusions need to be examined closely because they may not track the more familiar business risk exclusions found in the CGL policy. In addition, the policy may be subject to professional liability exclusions due to the nature of environmental remediation. For example, in *Denihan Ownership Co., LLC v. Commerce & Industry Ins. Co.*, 37 A.D.3d 314 (N.Y. App. Div. 2007), the court applied an exclusion barring coverage for cleanup costs, claims, or loss arising from pollution conditions associated with documents prepared by the insured landowner’s environmental consulting contractor.

While not extensive, the case law interpreting the provisions of PLL, CPL and similar pollution liability policies has been increasing in the last ten years. For example, in *Spirco Environmental, Inc. v. American Int’l Specialty Lines Ins. Co.*, 2007 WL 1460409 (E.D. Mo. May 16, 2007), the insured contractor was sued by the owner after completing asbestos removal and abatement in a building. The owner alleged that that it found asbestos remaining in the building and it refused to pay the contract balance. The court determined that the claim alleged “property damage,” i.e., physical damage, within the definition in the CPL policy before

it. It also held that the exclusion for liability assumed under contract did not apply since the liability was the contractor’s own and not the liability of a third party that the insured had assumed. Finally, the court determined that the property damage arising out of the abatement work was caused by “pollution conditions” as defined in the CPL policy.

For other cases, see *R.L. Vallee, Inc. v. American Int’l Specialty Lines Ins. Co.*, 431 F.Supp.2d 428 (D. Vt. 2006) (upholding coverage for insured contractor hired to remove and replace underground storage tanks at gas station, finding that leaks occurred during the period of the contractor’s CPL policy); *Nu-Way Environmental, Inc. v. Planet Ins. Co.*, 1996 WL 563188 (S.D.N.Y. Oct. 2, 1996) (the covered operations under CPL policy issued to an environmental contractor included property damage arising out of excavation and replacement of contaminated soil); *Lumbermens Mut. Cas. v. Commonwealth of Pennsylvania*, 52 A.D.3d 212 (N.Y. App. Div. 2008) (a procedural ruling denying state’s claim of sovereign immunity brought by PLL insurer as to claim for contamination of soil and groundwater arising out of excavation of soil containing pyretic material).

One of the contributing factors in the increased popularity of CPL policies was the increased risk of exposures related to water infiltration, primarily mold. Once mold became a routinely excluded risk within the construction industry, it was more important than ever for the management of that risk, to provide insurance coverage outside of the CGL policy. In response, CPL insurers often expressly extend the definition of pollutant to include fungi or bacterial matter, including mold and mildew. However, underwriting considerations dictated that such coverage be provided only through a smaller sublimit. Alternatively, in order to obtain a higher sublimit, an additional premium might be charged on a case-by-case basis. Still other insurers did not offer such coverage or enhancements at all. At this point, it would not appear that a CPL policy may need to be specially endorsed to provide coverage for Chinese drywall exposures, which appear to fall within the traditional chemical/toxic exposures within the scope of the definitions of “pollution events,” “pollution conditions,” and “pollutants” for which CPL and PLL policies are generally purchased. Nevertheless, the rapid addition of mold coverage to CPL policies indicates a willingness on the part of the insurance industry to provide a product that fills the gap created in the CGL by pollution or mold exclusions. That willingness may also extend to Chinese drywall claims.

For that reason, the tendency appears to be that carriers issuing both CGL and PLL policies to the same

insured will attempt to absolutely exclude pollution exposures from the CGL, and attempt to isolate them in a PLL-type policy. This may allow carriers to maintain more control over available sublimits, as well as to adjust deductibles, which are more common in PLL policies. Moreover, since PLL policies are usually written on a claims-made basis, avoidance of long tail losses may be accomplished.

VI. CONCLUSION

In short, specialized environmental coverages have assumed greater importance due to the tightening and limiting of coverage under the standard CGL policy. The Chinese drywall exposure makes alternative coverages to fill the gap created by the pollution exclusion in the CGL policy desirable. A well-constructed CPL or PLL, therefore, is of corresponding importance to insureds. Insureds and insurers alike will need to be creative to meet new challenges, as currently illustrated by the Chinese drywall problem.