

APRIL 2010 UPDATE ON INSURANCE COVERAGE FOR CHINESE DRYWALL CLAIMS

Recent Developments in Chinese Drywall Litigation

Several recent court rulings and filings have begun to dramatically shape the landscape for litigation arising from Chinese drywall claims. On April 8, 2010, the New Orleans federal court overseeing the massive Chinese drywall multi-district litigation issued a 108-page ruling against Taishan Gypsum Co., Ltd., f/k/a Shandong Taihe Dongxin Co., Ltd and awarded damages of \$2.6 million to seven affected homeowners. The court found that Chinese drywall created a corrosive environment that extensively damaged the affected homes. In arriving at the \$2.6 million award, the court computed the cost of remediation that should be completed on each house. The court concluded that *all* drywall (not just Chinese drywall), insulation, electrical wires, copper pipes, HVAC units, carpet, hardwood, and vinyl flooring and some electrical devices and appliances, tile flooring, cabinets, countertops, trim, crown molding, baseboards, and bathroom fixtures should be removed and replaced. The court computed the cost of repairing the homes to be an average of \$86 per square foot. The court stated that engineers should certify the safety of the homes after remediation and computed the costs for alternate living quarters for the plaintiffs. In addition to the costs of repair and remediation, the \$2.6 million award also included damages to personal property, alternative living costs, costs associated with foreclosures and/or bankruptcy, costs due to mortgage deferral or the inability to refinance and loss of income, and loss of use and enjoyment of the property. This ruling suggests that the cost of the Chinese drywall liability could exceed the previous damage estimates of \$100,000 per house.

Recent Developments in Chinese Drywall Insurance Coverage Litigation

In another courtroom development, on March 24, 2010, in an action brought by an insurer, a Virginia federal district court ruled against the insured homebuilder, Dragas Management Corporation (“Dragas”), and granted an insurer’s motion to dismiss Dragas’ breach of contract claim. *Builders Mutual Ins. Co. v. Dragas Mgmt. Corp.*, Civ. Action No. 2:09cv185 (E.D. Va.). After learning of potential third-party injury and property damage resulting from the installation of Chinese drywall by one of its subcontractors in over 70 homes, Dragas notified its insurers and instituted a remediation plan. Builders Mutual Insurance Company argued that it had no obligation to pay the remediation costs because Dragas remediated the properties even though it did not have a legal obligation to do so. The court agreed “at this juncture” that the complaint failed to allege sufficient facts to show that the remediation costs resulted from a legal obligation to pay because Dragas had not alleged any threatened lawsuits or specific demands made by homeowners. The court gave Dragas 14 days to amend its claim to allege facts sufficient to show a legal obligation to pay. Without those facts, Dragas’ insurer will avoid liability for Dragas’ remediation costs. Other insureds contemplating proactive steps to diminish Chinese drywall liability should closely examine the language in their insurance policies and ensure that they can establish a “legal obligation to pay” in the event that their insurers raise this defense.

Similar to the “legal obligation to pay” provision, insurers may assert the voluntary payment clause to bar coverage for Chinese drywall claims. The voluntary payments provision states that an insured will not voluntarily make a payment or assume an obligation without its insurers’ consent; failure to obtain consent can preclude coverage for the associated costs. Although Builders Mutual Insurance Company contended that Dragas’ remediation program constituted an uninsured voluntary payment, the Dragas court did not consider the provision because of the case’s procedural posture. As did the Dragas insurer, however, other insurers will likely raise both the legal obligation to pay and the voluntary payments provision to attempt to avoid liability for remediation programs.

As expected, the so-called “pollution exclusion” has also come into play in Chinese drywall coverage litigation. On March 30, 2010, in another insurance coverage case pending in Florida, the insurers moved for summary judgment on the ground that the pollution exclusion releases them from liability to their insureds. *Chartis Specialty Ins. Co. v. Banner Supply Co.*, Case No. 8:10-cv-00339-JSM-EAJ (M.D. Fla.) The court has not yet ruled on that motion. At least one other court recently rejected this argument, however. In *Finger v. Audubon Ins. Co.*, No. 09-8071 (La. Dist.

Orleans Parish), the court rejected the insurer's attempt to apply three exclusions to bar insurance coverage. The court held that the pollution exclusion applied only to environmental damage and was not intended to bar a residential homeowners' claims for damages caused by substandard building materials. The court also held that the gradual or sudden loss exclusion did not preclude coverage because the Fingers' losses related to drywall offgassing rather than wear or tear or gradual deterioration. Finally, the court held that the faulty, inadequate or defective planning exclusion did not apply because the drywall could potentially be used as a finishing material in certain geographical locations. Insurers in other Chinese drywall disputes will raise these same arguments. Because the Louisiana court has ruled favorably to policyholders, insurers will also endeavor to position litigation in states with more favorable law. As the case law continues to develop, policyholders should expect insurers to file more lawsuits against their insureds as the insurers attempt to posture coverage disputes in insurer-friendly jurisdictions.

New Federal Guidelines on Drywall Remediation

The U.S. Department of Housing and Urban Development and the U.S. Consumer Product Safety Commission issued interim remediation guidelines on April 2, 2010, which recommend that consumers remove all possible problem drywall, replace electrical components and wiring, gas service piping, fire suppression sprinkler systems, smoke alarms, and carbon monoxide alarms. Those guidelines and related materials can be accessed at the Drywall Information Center at <http://www.cpsc.gov/info/drywall/index.html>.

Availability of Insurance Coverage

Insurers and insureds are already engaged in serious litigation over the availability of insurance coverage to cover the costs arising from Chinese drywall litigation. Affected insureds should analyze all available coverage (including any coverage as additional insureds on other companies' policies) and immediately notify insurers of any claims or potential claims. Insureds should also expect insurers to resist coverage and in, some instances, to sue their insureds to obtain rulings in pro-insurer jurisdictions. A thoughtful insurance recovery strategy is critical for any company facing Chinese drywall liability.

Our Chinese Drywall Team

Our multi-disciplinary Chinese Drywall Team includes attorneys experienced in policyholder insurance coverage, construction, real estate practice, and litigation. Please contact any of the team leaders mentioned below for more information or assistance with Chinese drywall-related questions.

Katherine J. Henry

Katherine J. Henry represents policyholders seeking insurance coverage for all types of liabilities, including mass torts (such as asbestos, environmental, and welding), D&O and E&O, financial liabilities, and first-party property damage. Her past and present policyholder clients include the world's largest automaker, the world's largest home improvement specialty retailer, a major utility company, a major lender, numerous health care-related entities, a private-equity investment firm, several distributors of welding products, and a national trade association for the gases and welding industry. She successfully defeated an insurer's argument that the pollution exclusion barred coverage for welding liability claims; insurers are raising that same exclusion in Chinese drywall litigation. Katherine also provides clients with strategic advice and solutions for complex legal disputes. Her experience includes formulating a litigation and negotiation strategy that led to the industry-wide settlement of claims brought by the entire payphone industry as well as crafting a nationwide insurance coverage strategy for welding distributors. She is an effective appellate advocate and has appeared before numerous federal and state appellate courts, including en banc panels, on a wide variety of matters.

David Pharr

David Pharr represents commercial policyholders in insurance coverage matters and manufacturers and contractors in defense of their products and work. David represented an EIFS manufacturer in a complex dispute with multiple insurers arising from hundreds of homeowner claims involving business risk exclusions like those asserted in Chinese drywall matters. He also represented a steel processing company in coverage litigation focused on whether various pollution exclusions barred coverage for mass tort environmental liability claims. David also has experience with litigation and negotiation of hurricane damage claims involving property and builder's risk insurance. David regularly counsels businesses and organizations in matters related to insurance coverage. He is Vice-Chair of an American Bar Association committee on insurance coverage litigation and Chair of the Jackson Chamber of Commerce.

Keith Covington

Keith Covington practices construction and labor and employment law. He advises contractors and others in the construction industry on contracts, contract administration, and claims. Keith also counsels employers in virtually all aspects of employment law, including discrimination issues, workers' compensation, labor relations, worksite immigration enforcement, OSHA compliance, and union avoidance. Keith has broad experience litigating employment, construction, and construction defect cases. He was a member of Bradley Arant's EIFS team and represented Dryvit Systems during the recent spate of EIFS litigation. Keith is an active member of the Associated Builders and Contractors and a frequent writer and speaker on issues of interest to the construction industry. He is also a member of the Defense Research Institute and the American Immigration Lawyers Association. Keith holds a B.S. degree in Mechanical Engineering from Auburn University and a J.D. degree from the University of Alabama School of Law.

Mike Brown

Mike Brown leads the firm's Real Estate Litigation Team and is a member of the firm's Environmental and Toxic Tort Practice Group and the General Litigation Practice Group. His practice focuses on real property and land use matters, including construction and construction defects litigation. Since 1997, Mike has been one of the lead counsel for Dryvit Systems, Inc. in its litigation in Alabama and Mississippi. Mike also assisted the company in resolution of a nationwide class action on EIFS issues. He served as one of the lead lawyers in *Keck v. Dryvit Systems, Inc.*, 830 So.2d 1 (Ala. 2002), in which the Alabama Supreme Court established groundbreaking precedent on real property and construction matters. Mike serves as an adjunct Professor at the University of Alabama School of Law, where he teaches Land Use Planning and Real Estate Finance & Development.

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