

Tackling Pollution Exclusions To Chinese Drywall Claims

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Federal and state courts in Virginia, Florida, and Louisiana have now published at least twenty-one rulings on insurance coverage actions related to Chinese Drywall. The outcomes and dispositive issues have varied, with insurers prevailing so far in seventeen of the twenty-one major decisions. Where insurers have prevailed, courts have ruled that pollution, latent defect, faulty materials, or corrosion exclusions preclude coverage or that the insured lacks a legal obligation to pay sums as damages.

Some patterns have emerged from the decisions to date. The Chinese Drywall issue that has received the most judicial attention is application of pollution exclusions. Almost all of the twenty-one major decisions in these states have included pollution exclusion rulings, and these rulings are the focus of this article. With limited exceptions, courts in Virginia and Florida have found that pollution exclusions preclude coverage in Chinese Drywall cases. Judicial treatment from courts in Louisiana has been more mixed.

Virginia

Insurers have prevailed in four of the five Chinese Drywall insurance opinions in the Eastern District of Virginia, at least in part, based on the applicability of pollution exclusions. Additionally, an insurer was successful in defeating a Chinese Drywall claim in a Virginia state court case based on a pollution exclusion.

In June 2010, a court in the Eastern District of Virginia issued the first major pollution exclusion ruling favoring insurers, holding that a pollution exclusion acts, along with several other exclusions, to bar coverage for property insurance claims arising from Chinese Drywall. *Travco Insurance Co. v. Ward*, 715 F. Supp. 2d 699 (E.D. Va. 2010).

In this first-party homeowners context, the *Ward* court stated that “[u]nder Virginia law, pollutant exclusions are not limited to ‘traditional environmental pollution.’” Instead, such exclusions encompass damage caused by the release of pollutants in other contexts. The court concluded that the gases emitted from Chinese Drywall are pollutants; thus, the exclusion applies.

The *Ward* holding has been appealed to the Fourth Circuit Court of Appeals. The appeal has been fully briefed and argued.

In *Nationwide v. Overlook*, another court in the Eastern District of Virginia extended the *Ward* holding by ruling that a pollution exclusion applies to preclude coverage for defense and indemnity of third-party liability claims arising from Chinese Drywall

defects. *Nationwide v. Overlook*, No. 4:10cv69, 2011 U.S. Dist. LEXIS 55282 (E.D. Va. May 13, 2011).

In the underlying lawsuit, a homeowner sued the real estate developer that built his Richmond, Virginia home with defective Chinese Drywall. The underlying complaint stated that the homeowner's drywall "is inherently defective because it emits various sulfide gases and/or other toxic chemicals through 'off-gassing' that create noxious odors, and cause damage and corrosion."

Applying Virginia's Eight Corners Rule, the court compared the underlying complaint to the twenty-six primary and excess policies at issue and determined that the insurer did not have a duty to defend the developer because the pollution exclusions barred coverage for the homeowner's allegations.

To qualify for exclusion, the pollution exclusions required that the emission be a "solid, liquid, gaseous, or thermal irritant or contaminant," causing "bodily injury" or "property damage" by means of "discharge, dispersal, seepage, migration, release or escape." The court concluded that emission of gases from Chinese Drywall satisfies each element of the policies' pollution exclusions and that, additionally, each claim in the underlying suit implicated the pollution exclusion.

In reaching its holding, the court rebuffed the homeowner and insured's contention that policy exclusions in Virginia are subject to a "reasonableness" standard or that the exclusion is overly broad so as to lead to absurd results. In declining to apply a reasonableness standard, the court explained that it would not "impute to the Supreme Court of Virginia a desire to engage in an analysis of the substantive reasonableness of each exclusion in an insurance policy."

The court also rejected the insured's argument that the pollution exclusion should apply solely to so-called "traditional environmental pollution," noting that this contention is inconsistent with Virginia precedent.

The *Builders Mutual Insurance Co. v. Parallel Design & Development* decision, issued on the same day and by the same judge as the *Overlook* decision, reached an opposite result. No. 4:10cv68, 2011 U.S. Dist. LEXIS 55279 (E.D. Va. May 13, 2011). In this case, the court ruled that a policy's pollution exclusion did not apply to limit coverage to the very same homeowners' lawsuit because the apparently undefined term "pollutants" could be ambiguous. The court noted that the policy's failure to define the term distinguished the *Parallel Design* case from the vast majority of cases where courts have considered the applicability of pollution exclusions.

Considering the undefined term "pollutants," the court held that it could reasonably be read in two ways: either as pertaining only to "traditional environmental pollution," as put forth by the insured; or more broadly, as encompassing "non-traditional environmental pollution," as the insurer argued. While acknowledging that dictionary definitions are not conclusive, the court noted that such sources often assign the term "pollutant" an outdoor environmental connotation. The court also opined that other language in the

policy did not help clarify the term. This case has been appealed to the Fourth Circuit, as has *Overlook*.

However, in recent months, two other judges in the U.S. District Court for the Eastern District of Virginia followed the holdings of *Ward* and *Overlook* by denying coverage relating to the alleged damage from Chinese Drywall based on the pollution exclusion. *Dragas Mgmt. Corp. v. Hanover Ins. Co. et al*, No. 2:10cv547, 2011 U.S. Dist. LEXIS 87132 (E.D. Va. Aug. 8, 2011); *Evanston Insurance Co. v. Harbor Walk Develop., LLC*, No. 2:10cv312, 2011 U.S. Dist. LEXIS 109807 (E.D. Va. Sept. 9, 2011).

Also in May 2011, a Virginia state court applied a pollution exclusion, reaching a result similar to the line of Virginia federal court Chinese Drywall cases. As in *Ward*, the state court concluded that the plain meaning of the pollution exclusion unambiguously acted to bar coverage for a first-party homeowners claim. *Proto v. The Futura Group*, No. CL09-2455 (Va. Cir. May 6, 2011).

The *Proto* court also noted that another provision in the pollution exclusion, accounting for “smog and smoke from industrial pollution” undercut the insured’s contention that the pollution exclusion should be construed narrowly. That court reasoned that if the insured’s interpretation were correct, the provision would not have referred specifically to industrial pollution elsewhere in the exclusion. The court also observed that the exclusion expressly barred coverage for harm from pollution “no matter how caused.”

Florida

In Florida, insurers have so far prevailed in nine of the ten Chinese Drywall-related decisions that have addressed a pollution exclusion. In the nine cases where insurers were successful, courts ruled that pollutions exclusions operate to bar coverage. However in a tenth case, a Florida federal court ruled that a pollution exclusion in a liability insurance policy does not bar coverage where the exclusion’s language limits its scope to locations where contractors “are performing operations.”

In *General Fidelity Insurance Co. v. Foster*, a court in Florida found that a liability insurance policy’s pollution exclusion acts to bar coverage. No. 9:09-cv-80743-KMM (S.D. Fla. Mar. 24. 2011). In the underlying lawsuit, the affected homeowner sued the homebuilder for installing Chinese Drywall, alleging that it contains “excessive amounts of ... sulfur and strontium and as a result causes damage and corrosion ... to home structure and mechanical systems” and that the excess sulfur also causes a “‘rotten egg’ smell ... which is capable of ... causing health problems.”

Considering the allegations of this complaint, the court found that the pollution exclusion relieved the insurer of any duty to defend. Specifically, the *Foster* court found that the sulfur and other compounds released by Chinese Drywall qualify as “pollutants” under a definition that includes “any ... gaseous ... irritant or contaminant.” Although the policy did not define “irritant” or “contaminant,” the court referred to dictionary definitions to establish that the gases released by the defective drywall would qualify.

The *Foster* court also rejected the insured's argument that pollution exclusions pertain only to "environmental" or "industrial" pollution. Indeed, the Florida Supreme Court has specifically held otherwise when such exclusions are stated unambiguously. *Deni Assocs. of Florida, Inc. v. State Farm Cas. Ins. Co.*, 711 So.2d 1135 (Fla. 1998).

Eight separate Florida decisions have likewise barred coverage for third-party claims based on pollution exclusions. On each occasion, the court ruled that an insurer does not have a duty to defend underlying allegations against its insured for installing defective Chinese Drywall. *E.g.*, *FCCI Commercial Insurance Co. v. MDW Drywall, Inc.*, No. 10-CA-007389 (Fla. Cir. July 6, 2011); *FCCI Commercial Insurance Co. v. Ocean Construction, Inc.*, No. 10-CA-2841, (Fla. Cir. June 6, 2011); *FCCI Commercial Insurance Co. v. Al Brothers, Inc.*, No. 10-CA-002840 (Fla. Cir. Apr. 21, 2011).

In each case, the pollution exclusions barred coverage for injury or damage "which would not have occurred but for the ... release ... of 'pollutants.'" The court stated that "Total Pollution Exclusion[s]" like the one contained in the general liability policies at issue here have consistently been found unambiguous by Florida courts.

The court concluded that the gases released from Chinese Drywall qualify as "contaminants" or "irritants" according to those terms' plain meaning, and that such gases are rightly characterized as "pollutants" under the pollution exclusion. Thus, the court found that coverage was properly excluded and that the insurer had no duty to defend in the underlying actions.

Considering different facts and a differently worded pollution exclusion, one judge in the Middle District of Florida found that the exclusion did not bar coverage for defense of an underlying lawsuit. In that case, the insured was a drywall supplier, and the pollution exclusion expressly limited its application locations where an insured or its contractors "are performing operations." *Auto-Owners Insurance Co. v. American Building Materials, Inc.*, No. 8:10-cv-313-T-24-AEP, 2011 U.S. Dist. LEXIS 52837 (M.D. Fla. May 17, 2011). Thus, the pollution exclusion at issue applied to "[b]odily injury or 'property damage' arising out of the ... release ... of pollutants ... at or from any premises ... on which any insured or any contractors or subcontractors working ... on any insured's behalf are performing operations...." (emphasis added).

In these circumstances, the *American Building Materials* court found that the phrase, "are performing operations," means that, to be excluded, a claim must arise "at the time the work is being performed." Since the insured's operations were completed when it delivered the drywall, and before the drywall began to release pollutants, the court found that the exclusion did not apply.

Louisiana

State courts in Louisiana have issued rulings on the application of pollution exclusions in two first-party Chinese Drywall claims and have reached opposite conclusions, with a Louisiana appellate court favoring exclusion of coverage. A federal district court

considering ten consolidated Chinese Drywall cases ruled that the pollution exclusion did not apply to preclude coverage under Louisiana law.

In *Finger v. Audubon Insurance Co.*, a Louisiana state court ruled that several exclusions in a homeowners policy, including a pollution exclusion, failed to preclude coverage for Chinese Drywall damages. No. 09-8071 (La. Civ. Dist. Ct. Mar. 22, 2010). Specifically, the *Finger* court found that the policy's pollution exclusion was not intended "to apply to residential homeowners claims for damages caused by substandard building materials." In *Finger*, the first-party pollution exclusion at issue precluded coverage for property damage arising out of the discharge of a pollutant unless the discharge was caused by a named "Peril Insured Against."

The *Finger* court relied on the Louisiana Supreme Court's 2000 ruling addressing the application of pollution exclusions under Louisiana law. *Doerr v. Mobil Oil Corporation*, 774 So.2d 119 (La. 2000). In *Doerr*, the Louisiana Supreme Court stated that the total pollution exclusion should be construed to exclude coverage for "environmental" pollution but not to encompass "all interactions with irritants or contaminants of any kind." Reviewing a commercial liability policy, the *Doerr* court stated that the exclusion's applicability turned on several factual considerations: whether the insured is a "polluter"; whether the substance at issue is a "pollutant" within the meaning of the exclusion; and whether there was a ...'release'...of a pollutant by the insured within the meaning of the policy."

The *Finger* court also pointed to a 1997 Louisiana Department of Insurance determination that a "pollution incident" in a pollution exclusion refers to traditional environmental damage.

Later in 2010, a Louisiana federal judge hosting the Chinese Drywall Multi-District Litigation similarly followed *Doerr* in concluding that pollution exclusions do not apply to preclude coverage for damage from Chinese Drywall under Louisiana law. *In re: Chinese Manufactured Drywall Products Liability Litigation*, No. 2:09-md-02047-EEF-JCW, MDL No. 2407 (E.D. La. Dec. 16, 2010). In that case, the court considered motions by ten homeowner insurers that issued policies to Louisiana homeowners on properties containing Chinese Drywall. Although the decision ultimately favors insurers, finding that coverage is excluded on other grounds, Judge Fallon concluded that the *Doerr* considerations would apply to preclude operation of the pollution exclusion in homeowners policies.

An appellate court in Louisiana has since taken an opposite view on the application of a pollution exclusion to damage from Chinese Drywall. In *Ross v. C. Adams Construction & Design*, a Louisiana appeals court found that a pollution exclusion is among several exclusions that apply to bar coverage in a first-party homeowners claim. No. 10-CA-852, 2011 La. App. LEXIS 769 (La. App. 5 June 14, 2011). The appellate ruling affirms the trial court decision which awarded summary judgment to the insurer without explanation.

The appeals court held that the pollution exclusion precluded coverage for loss caused by pollutants, defined as "... any gaseous ... irritant or contaminant ...[.]" The court concluded that the sulfuric gas emitted from the Chinese Drywall meets this definition.

Conclusion

To date, the great majority of courts to consider the issue have found that pollution exclusions bar coverage for both first- and third-party insurance claims in the Chinese Drywall context. The exceptions are cases which present unique facts or specific circumstances, including pre-existing law that disfavors the pollution exclusion in non-industrial contexts. Several important appeals are pending, so it is likely that the law will become still more defined in the next six months.

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