

Chinese Drywall

A threat to commercial insurers-- and to free trade

You may have read that 14 U.S. commercial insurers have been served with a complaint related to coverage for defective drywall. You might say that free trade itself is on trial.

No matter what is litigated or settled in U.S. courts, the case is overshadowed by the specter of Taishan Gypsum Co. failing to answer a summons from a U.S. court.

Taishan is owned by the government of the People's Republic of China, and it is the largest Chinese manufacturer of drywall accused by many in the U.S. of causing ailments in humans and damage to property.

Taishan's stance, to date, makes real a fear that many had anticipated: What happens if the ultimate source of a loss is inaccessible? How is the loss then shared?

Problem

Large amounts of drywall were imported from China during the U.S. housing boom of the 2000s and installed in housing throughout the U.S., particularly in the Southeast.

Around the middle of the decade, people in homes with Chinese drywall began to complain of headaches, watery eyes, sore throats, and other symptoms, and that copper wires and air-conditioning coils were becoming tarnished and corroded.

Still, it is not entirely clear to what extent "Chinese drywall" is a hazard to humans and property.

Two reports issued by the U.S. Consumer Product Safety Commission (CPSC) in late 2009 are a study in contrasts.

One, done in conjunction with the U.S. Environmental Protection Agency, said that reportedly elevated levels of certain chemicals associated with drywall imported from China did not pose a risk to health or property. The elevated levels were found in homes with and without Chinese drywall.

A week later, however, another CPSC-commissioned study reported that there was a link between the presence of drywall imported from China and corrosion of metal components in homes.

The second report also reported that the chemicals appeared "below irritant levels" for humans in the homes studied, but added that "it is possible that the additive or synergistic effects of these and other compounds in the subject homes could cause irritant effects."

If chemicals emitted from drywall are a problem, the problem may not be limited to drywall imported from China. A suit filed in Florida claims that sulfide gases similar to those allegedly emitted by Chinese drywall were also emitted by drywall manufactured in Canada by a U.S. company.

Damage

While the physical effects of defective drywall are still to be determined, its economic effects are clear.

Problems blamed on drywall forced one major Florida developer, WCI Communities, into bankruptcy and forced another, Lennar Homes, to replace drywall in scores of homes.



Hundreds of other developers and contractors are likely to face claims in the coming months and years.

There are reports that homeowners have filed claims under their homeowners insurance policies, presumably for property damage (corrosion) arising from a peril not excluded (presuming that most homes affected are insured for open perils).

There are no reports of judgments against homeowners carriers at this early stage, and homeowners insurers have several lines of defense against such claims:

- “Wear and Tear” exclusions explicitly exclude building property coverage for “latent defect, inherent vice, or any quality . . . that causes it to damage or destroy itself.” Also excluded is “rust or other corrosion . . . “
- “Errors, Omissions, and Defects” exclusions explicitly exclude coverage for losses that result from defects or inadequacy in workmanship or materials.
- Pollution exclusions have been broadly interpreted in recent years to exclude coverage for any type of irritant.

Vulnerabilities

There may be vulnerabilities to these defenses, however, according to Charles Miller of the Insurance Law Center, Berkeley, Calif.

In a report to the recent winter meeting of the National Association of Insurance Commissioners, Miller said that wear and tear exclusions may not apply if the drywall is not damaging itself but other property.

He added that many courts have found that pollution exclusions in homeowners policies apply only to environmental damage as traditionally understood.

Even if Miller is correct, homeowners insurers would only be responsible for repairing or replacing property damaged by an insured peril. Unless there is truly a stunning verdict, homeowners carriers should not be on the hook for wholesale replacements of defective drywall.

The Insurance Information Institute notes, however, that homeowners insurers could face more substantial claims if large numbers of homeowners abandon homes with defective drywall. If that happens, there could be an increase in the number of ensuing losses due to fire, theft, vandalism, and other causes.

A recent class action suit related to defective drywall named more than 600 defendants, including lumber suppliers, property management firms, and real estate agents, as well as builders.

“Forcing the builders and other defendants into financial ruin will accomplish nothing for the homeowners.”

— Christopher Burton, CEO
National Construction
Warranty Corporation

Also, United Policyholders, an NAIC-funded consumer advocacy group, has suggested that homeowners insurers cover claims arising from Chinese drywall, then subrogate against entities found to be responsible.

Commercial

Clearly, if the U.S. property/casualty industry is greatly impacted by losses arising from defective drywall, it will be in commercial lines.

The potential losses are staggering, as the cost of gutting a house and replacing drywall can be almost as much as the cost of rebuilding it entirely.

Given that most major manufacturers of problem drywall have been unresponsive, the U.S. courts may be left to determine the share of professional, contractual, and general liability to be borne by U.S. building contractors and their insurers. (One China-based company, the internationally owned Knauf Plasterboard Tianjin Co. Ltd., has responded to summonses.)

General Reinsurance reports that a recent class action suit related to defective drywall named more than 600 defendants, including lumber suppliers, property management firms, and real estate agents, as well as builders.

Attorneys H. Lockwood Miller and George Kelman, writing in a publication of the Defense Research Institute, state that plaintiffs' claims in individual suits and class actions “are based on a variety of legal theories, including product liability, negligence, breach of implied and express warranties, breach of contract, violation of consumer fraud laws, fraudulent concealment/misrepresentation, and private nuisance.”

While the claims pile up, there appear to be no definitive rulings to date on how standard liability policies should respond to drywall claims.

In one of the earliest cases, filed in a federal court in Virginia in April 2009, Builders Mutual Ins. Co., Raleigh, N.C., invoked the “your work” and pollution exclusions to deny defense and indemnification coverage to a Virginia developer.

“The off-gassing of sulfur compounds from the Chinese drywall clearly constitutes the ‘actual, alleged or threatened discharge, dispersal, seepage, migration, release or escape of pollutants,’” Builders Mutual argues in its pleadings. “The compounds, which are known to be contaminants and irritants, clearly come within the definition of pollutants.”

In response, the developer is alleging bad faith by Builders Mutual. To date, there has been no ruling.

Causes

Perhaps the biggest act in the drama will take place in the U.S. District Court for eastern Louisiana. That’s where the WCI Drywall Trust, created to assume the drywall-related liabilities of a developer bankrupted by the problem, has sued the 14 commercial insurers.

The complaint, lodged on behalf of owners of WCI-built homes, claim bodily injury and property damage, which would trigger a response under general liability policies.

In addition, a homeowners’ class action suit against WCI and other developers argues that the drywall rendered their homes “essentially uninhabitable,” raising the question whether there might be personal injury exposure for loss of use and enjoyment of private property.

Standard general liability policies limit such personal injury coverage, however, to “invasion of the right of private occupancy” committed by or on behalf of an owner, landlord, or lessor of the premises.

Ultimately, the question in the courts will come down to this: Were the artisans, contractors, and developers who installed defective drywall negligent? Surely they would



The right pick

INS PRO a fully integrated Insurance Processing System
Customized for your needs.

- Complete Policy Management Rating, Quoting and Policy Issue fully supporting AAIS Lines in multiple states
- Premium and Loss Accounting Billing and Claims
- Management Information and Supplemental File systems for complete system reporting
- System Security Controls Agent On-Line Access
- Web Quoting and SQL Database
- Interfaces with Document Management and Workflow Systems - Mortgagee Notification - Accounting Packages - MIB Inspections - SDN Search - EFT - and MS MapPoint
- Policy & Claim number link with imaged files
- Friendly Professional Support and Training
- Affordable for even the smallest companies
- Robust to grow with larger companies
- MSP Medicare Reporting

Town and Country Computer Services, LLC
3418 Carman Road - Schenectady, NY 12303
(800) 388-7779 • sales@tccs-inspro.com
www.tccs-inspro.com

TCCS

be today if they installed drywall without inquiring into its properties, but can that standard be applied to a time when no one suspected such a problem?

Sharing

What happens if insurers prevail by making the case that responsibility for the effects of defective drywall properly belong to builders and contractors as a business risk?

They may well be tapped anyway for contributions to public programs for correcting the problem.

“Forcing the builders and other defendants into financial ruin will accomplish nothing for the homeowners,” writes Christopher Burton, CEO of the National Construction Warranty Corporation, in a proposal for a class action repair settlement for properties with defective drywall.

Burton proposes a settlement that would establish a government agency program to inspect homes and verify repairs that would be backed by a third party national warranty.

Under the proposal, builders, developers, and homeowners, as well as installers, retailers, and distributors of defective drywall, would each have a share of the cost of the remediation program.

If funds are ever recovered from offshore producers of the drywall, homeowners would be reimbursed.

“By setting aside legal interpretations, jurisdictional disputes and policy language, defendants can participate without exposure to excessive legal costs or inflated jury awards,” he adds.

The rub for insurers, however, is that the proposal would tap insurers for each of the participating parties bearing part of the cost.

Will it be worth it? Only time will tell. ■