

# THE NOT-SO-GREAT DRYWALL OF CHINA

## *Insurance and Financial Implications of Defective Chinese Drywall upon the Construction Industry*

By Jeffrey J. Vita and David G. Jordan\*

The recent domestic drywall shortage, caused largely by increased demand for building materials in the aftermath of Hurricane Katrina, has led to an increased use of “Chinese Drywall” for new-home construction projects.<sup>1</sup> Unfortunately, this drywall has been discovered to be defective. Sulfuric compounds within the drywall have had a corrosive effect, leading to damage of copper plumbing pipes, electrical outlets, air-conditioning coils, and other metallic utilities and furnishings.<sup>2</sup> The sulfur in the Chinese Drywall also emits a “rotten-egg” smell, allegedly resulting in nausea, headaches and mild respiratory problems.<sup>3</sup> Toxicologists are presently performing tests on the material to determine if it poses even more serious health risks.<sup>4</sup>

It is estimated that from 2006 to the present, Chinese Drywall has been utilized in as many as 250,000 homes across the nation, with the greatest concentration in Florida.<sup>5</sup> Studies show that the drywall itself cannot be remedied or covered-over with a special paint, but must be entirely removed and

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<sup>1</sup>Tara E. McLaughlin, *No quick fix for Chinese drywall problems, experts say*, NAPLESNEWS.COM, Feb. 25, 2009, <http://www.naplesnews.com/news/2009/feb/25/no-quick-fix-chinese-drywall-problems-experts-say>.

<sup>2</sup> Mary Wozniak, *Defective Chinese drywall said to be prevalent*, NEWS-PRESS.COM, March 6, 2009, <http://www.news-press.com/article/20090305/NEWS01/903050357/1002/news01>.

<sup>3</sup> See *id.*

<sup>4</sup> See *id.*

<sup>5</sup> See *id.*

replaced.<sup>6</sup> This remediation will be at an enormous cost. Not surprisingly, the present and anticipated future litigation surrounding the use of this drywall likely will have considerable financial implications upon those contractors, subcontractors and suppliers that have performed any work with this product. What is worse is that the key manufacturer of the drywall, Knauf Plasterboard Tianjin Co. LTD, purportedly has no insurance.<sup>7</sup>

For these reasons, it is extremely important that companies having any involvement with Chinese Drywall put their insurance carriers on notice of potential claims. Such notice should include all potentially available insurance sources including general liability, professional liability and additional insured coverage. Moreover, all policy periods dating from the date work commenced to the present should be considered. Owners of property damaged by Chinese Drywall, residential or commercial, should also make claims under their first party property policies.

Notice alone, however, will not completely alleviate the impending costs faced by those connected to Chinese Drywall. Rather, policyholders should anticipate the possibility that coverage will be declined and should be prepared to challenge such determinations. Pollution exclusions as well as defective construction exclusions (i.e. "business risk") are, in particular, likely to be relied upon by insurance carriers in support of claim denials.

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<sup>6</sup> Tara E. McLaughlin, *No quick fix for Chinese drywall problems, experts say*, NAPLESNEWS.COM, Feb. 25, 2009, <http://www.naplesnews.com/news/2009/feb/25/no-quick-fix-chinese-drywall-problems-experts-say>. See also *Florida Homeowners Sue Makers of Chinese Drywall*, attorneyatlaw.com, March 2, 2009, <http://www.attorneyatlaw.com/2009/03/florida-homeowners-sue-makers-of-chinese-drywall/>.

<sup>7</sup> Gray Rohrer, *Builders convene over foreign drywall*, Cape-Coral-Daily-Breeze.Com, February 26, 2009, <http://www.cape-coral-daily-breeze.com/page/content.detail/id/503574.html?nav=5011>.

Application of these exclusions will depend, in part, upon the particular state law under which the dispute is determined. Thus, choice-of-law could be critical to coverage. For example, some states, such as New Jersey, apply a “traditional pollution” standard meaning that the pollution must involve an environmental catastrophe caused by reckless or intentional conduct (such as dumping of hazardous waste) in order to be excluded.<sup>8</sup> Other courts such as Minnesota, apply the pollution exclusion more broadly, to also exclude claims involving negligent use or handling of toxic substances that occur in the ordinary course of business (such as an unintended dispersal of carbon monoxide).<sup>9</sup>

Similarly, certain courts deem defective work to be accidental and thus an “occurrence” triggering liability insurance, while others hold that liability insurance is not designed to act as a surety bond for damages from the builders’ own defective construction. The latter courts consider such losses to constitute excluded business risk. Other jurisdictions apply a hybrid of these rules, finding that the defective work itself is excluded (e.g. the Chinese Drywall) but that non-defective work damaged by the defective work (e.g. the copper piping, electrical outlets etc.) is covered. These are just some examples of the myriad of insurance issues that are likely to surface once Chinese Drywall lawsuits begin to gain steam.

While there is a great deal of uncertainty surrounding the applicability of insurance coverage for Chinese Drywall damage, it should be remembered that such damage is indeed fortuitous. It has not been claimed that this product was

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<sup>8</sup> See e.g. Nav-Its, Inc. v. Selective Ins. Co. of Amer., 869 A.2d 929, 937 (N.J. 2005).

<sup>9</sup> See e.g. Continental Cas. Co. v. Advance Terrazo & Tile Co., 462 F.3d 1002 (8th Cir. 2006) (interpreting Minnesota law).

known to be defective at the time of installation. Therefore, while claim acceptance cannot be guaranteed, the potential for coverage exists. Putting all applicable carriers on notice is the only way to be sure that there is at least a chance of insurance recovery and thus avoidance of what could be catastrophic losses.

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