

## When Pervasive Foul Odors Constitute Property Damage

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It is settled law in New York that a commercial liability policy does not cover an insured's breach of contract that is not the consequence of an "occurrence" causing physical injury or property damage. Is a commercial general liability insurer liable for its insured's breach of contract if the insured botches a building renovation resulting in foul odors permeating the building so much so that tenants move out and stop paying rent?

### Third-Party Liability Coverage

Under New York law, an "occurrence" does not include claims for mere faulty workmanship of the insured, but rather only for consequential third-party damage resulting from the insured's activity. *J.Z.G. Resources Inc. v. King*, 987 F.2d 98, 102 (2nd Cir. 1993). While New York courts generally acknowledge that a CGL policy does not insure for damage to the work product itself, it does insure "faulty workmanship in the work product which creates a legal liability by causing bodily injury or property damage to something other than the work product." *George A. Fuller Co. v. U.S. Fid. & Guar. Co.*, 613 N.Y.S.2d 152, 155 (1st Dep't 1994); *Aquatectonics Inc. v. The Hartford Cas. Insurance Co.* (E.D.N.Y. Mar. 26, 2012).

Let's assume the building owner can show that its contractor (the insured) failed to install the insulation in strict accordance with manufacturer specifications, i.e., the insured's faulty workmanship caused consequential damage when the odor from the insulation permeated the building's carpet and ceiling tiles, necessitating their replacement and requiring tenants temporarily to vacate the premises. If the above rules were applied to such a case, there would not be an "occurrence" if the only property damage alleged was the remediation of the insured's faulty insulation.

However, assuming arguendo that the bad odor emanating from the faulty insulation caused "property damage" as defined under the policy to other parts of the building that were not within the scope of the insured's work, then is there an "occurrence" that will "trigger" coverage under the policy? And assuming an "occurrence," is there also CGL coverage for the building's air testing and purification expenses? Yes to all, according to *Essex Insurance Co. v. BloomSouth Flooring Corp.*, 562 F.3d 399, 406 (1st Cir. 2009), a First Circuit CGL decision that was one of the earliest cases — and thus far the only significant third-party coverage case — finding an occurrence and property damage from pervasive odors.



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Many CGL policies broadly define property damage as both physical injury to tangible property and loss of use of tangible property that is not physically injured. In addressing whether odors caused by an insured's faulty workmanship that permeate portions of the building separate from and unrelated to the insured's work will constitute covered "property damage," a court will look to the policy's definition of "property damage."

In *Essex*, the First Circuit held that an offensive odor permeating the premises from the installation of new carpeting constituted physical injury when it rendered the building unusable. As in our hypothetical, *Essex* involved a coverage dispute between the insurer, *Essex*, and its insured contractor, *BloomSouth*, in relation to a faulty workmanship claim. The CGL policy defined "property damage" as "[p]hysical injury to tangible property, including all resulting loss of use of that property," and "[l]oss of use of the work" for which it was hired. *BloomSouth* installed a carpet at the premises. Sometime thereafter, the occupants noticed an offensive odor, which caused some of the occupants to become ill. Whether the bodily injury allegations tipped the *Essex* court in favor of finding coverage, we will never know, but in any event pervasive odors are likely to attract a court's attention.

Despite remediation of the carpet, the smell spread to other areas of the building. Suit was commenced against *BloomSouth* for defectively providing and installing carpet that resulted in damage to and loss of use of the building, damages for attempts to eliminate the odor, including installation of carbon air filters to the building's ventilation system, bead blasting of the concrete floor, and the removal and replacement of the carpet that *BloomSouth* had installed.

### **First-Party Property Damage**

To date, no reported New York decision — either first- or third-party — has held that permeating odors constitute property damage. The Appellate Division, Fourth Department came fairly close in 1988 when it held in a third-party case that the physical properties of gases escaping from the installation of foam insulation caused property damage to vapor barriers and the roof membrane of a building. *Apache Foam Prods. Div. v. Continental Insurance Co.*, 528 N.Y.S.2d 448 (4th Dep't 1988). Until recent years, only a few scattered cases from around the country had held, in either a first- or third-party setting, that permeating odors could cause property damage. Today, the case law may be changing but, with the single exception of *Essex*, only in the first-party arena.

### **Cases Finding No Coverage**

As recently as 2012, the Sixth Circuit held firmly to a no coverage position, citing a 2005 Texas appellate decision; both of these were first-party cases. In *Universal Image Productions Inc. v. Fed. Insurance Co.*, 475 Fed. App'x 569, 575 (6th Cir. 2012), the insured attempted to recover for mold and bacteria contamination. The court observed that, unlike in *Essex*, there was no evidence that the odor in the case before it permeated the entire building; rather, it was confined to one floor. The court considered the insured's "damage" as intangible harms, such as pervasive odor, mold and bacterial contamination, and water damage. Ultimately, the court opined that these types of harms did not constitute physical loss.

In defending its position, the Sixth Circuit cited to *De Laurentis v. United Servs. Auto. Ass'n*, 162 S.W.3d 714, 716 (Tex. Ct. App. 2005), to determine whether mold constitutes "direct physical loss." In that case, the insured submitted a claim for mold damage requiring the remediation of her furniture and personal property. The insurer denied the claim, asserting that mold damage did not constitute "physical loss." The Texas court relied upon dictionary definitions, holding that a "physical loss" is "simply one that relates to

natural or material things.”

However, the policy language in both *De Laurentis* and *Universal* is different from several more recent iterations of CGL wordings. The court in *Universal* made its decision relying heavily on the policy language “direct physical loss,” as contrasted with policy language that states: “[p]hysical injury to tangible property.” Additionally, the court noted that even if its *De Laurentis* analysis was not on point, the insured’s mold issue did not cause damage to the degree of forcing people to leave the premises, nor it did it extend beyond a narrow area. In contrast, in our hypothetical there may be a different conclusion, with no policy language referring to “direct” physical damage and the presence of a more severe odor that permeated other portions of the owner’s premises, forcing tenants from the damaged area.

Other courts too, however, have continued to opt for relatively narrow definitions of “physical damage,” citing as recently as 2014 to the discussion in *Couch on Insurance* of what triggers such coverage. In *Advanced Cable Co. v. Cincinnati Insurance Co.*, No.13-cv229 (W.D. Wis. June 20, 2014), analyzing the threshold of physical damage necessary for recovery for hail damage to the insured’s roof, the court cited to *Couch* in defining physical damage. As the court noted, “[a]s with any insurance, property insurance coverage is ‘triggered’ by some threshold concept of injury to the insured property. ... In modern policies, especially of the all-risk type, this trigger is frequently ‘physical loss or damage,’ but may be any of several variants focusing on ‘injury,’ ‘damage,’ and the like. ... There is little question this threshold has been met when an item of tangible property has been physically altered by perils like fire, or water.” 10A *Couch on Insurance* § 148:46 (3d ed. 2013), available at Westlaw Couch; accord, e.g., *Port Auth. of N.Y. and N.J. v. Affiliated FM Insurance Co.*, 311 F.3d 226, 235 (3d Cir. 2002) (“[i]n ordinary parlance and widely accepted definition, physical damage to property means ‘a distinct, demonstrable, and physical alteration’ of its structure”). While *Advanced Cable* and *Port Authority* were both discussing relatively clear, tangible physical damage to the property, the decisions illuminate that some courts still adopt a more literal interpretation of “physical.”

### **Cases Finding Coverage**

While *Essex* is the only CGL case of significance to have found insurance coverage for such a claim, a number of first-party cases after 2009 — but accelerating in 2014 — have reached a similar conclusion. In *Travco Insurance Co. v. Ward*, 715 F. Supp. 2d 699 (E.D. Va. 2010), the insured sought coverage under his homeowners policy for damages allegedly caused by defective drywall that released sulfuric gas into the premises. The suit alleged that the drywall in his home “emits various sulfide gasses and/or other toxic chemicals ... that create noxious odors and cause damage and corrosion.”

Although the *Travco* policy did not define the term “direct physical loss,” it defined “property damage” as “physical injury to, destruction of, or loss of use of tangible physical property.” *Travco* argued there was no direct physical damage because such a loss requires some physical alteration or injury to the property’s structure and the drywall itself remained “physically intact, functional and has no visible damage.” The insured argued that there had been “property damage,” and thus direct physical loss, because he was forced to leave his residence as a result of the noxious odors. The *Travco* court ultimately sided with the insured, finding that the insured’s home was rendered uninhabitable by the toxic gases released by the drywall and, thus, the property had sustained direct physical loss or damage. The court’s conclusion that the insured had suffered a direct physical loss was strengthened by the fact that the policy specifically defined “property damage” to include “loss of use of tangible property,” which is similar to the language found in *Essex* and many current policies.

The 2014 first-party decision of the Southern District in *Newman Myers Kreines Gross Harris v. Great Northern Insurance Co.*, 17 F. Supp. 3d 323 (S.D.N.Y. 2014), provides some insight into how a New York

federal court might view a claim for “direct physical loss or damage” resulting from odors or fumes. In *Newman Myers*, the sole issue presented was whether the insured’s claim for loss of business income and expenses suffered as a result of a power outage brought about by Superstorm Sandy constituted “direct physical loss or damage” under its property policy.

Although that particular claim did not involve an odor, the insured relied for support on several out-of-state decisions, each holding that the presence of odors, fumes or noxious gases in a workplace was “direct physical loss or damage” because the property at issue was rendered unusable or unsatisfactory for its intended purpose. The court reasoned that, although these cases did not involve tangible, structural damage to the architecture of the premises, in each case there was some compromise to the physical integrity of the workplace. Critical to the court’s analysis, however, was that the policy term at issue, requiring “physical loss or damage,” did not require that the damage be tangible, structural or even visible. The *Newman Myers* court felt that the invasions of noxious or toxic gases in two of the cases in particular, although not tangible as typically understood, rendered the premises unusable or uninhabitable because “invisible fumes can represent a form of physical damage.” *Newman Myers* grounded its reasoning in both the first-party *Travco* case and the third-party *Essex* case.

Later in 2014, the New Jersey federal district court decided *Gregory Packaging Inc. v. Travelers Prop. Cas. Co. of Am.*, Civ. No. 2:12-cv-04418 (WHW) (D.N.J. Nov. 25, 2014), another first-party case. The court concluded that under New Jersey law the release of ammonia “physically transformed the air” in the facility, rendering it “unfit for occupancy until the ammonia could be dissipated.” The court then held that the ammonia discharge constituted physical loss under Georgia law, because it “physically changed the facility’s condition to an unsatisfactory state needing repair.”

Only a year ago, the New Hampshire Supreme Court opined on the issue of whether pervasive odor constituted an occurrence. In *Mellin v. Northern Sec. Insurance Co. Inc.*, 115 A.3d 799 (N.H. 2015), a first-party case, the insureds sued for the loss of use of their apartment from cat urine odor emanating from a neighboring apartment. The insureds argued that they were entitled to coverage because “physical loss” includes pervasive odors. The court rejected the insurer’s argument that a physical loss requires “tangible alteration to the appearance, color, or shape” of the covered apartment. Alternatively, the court opined that “physical loss need not be read to include only tangible changes to property that can be seen or touched, but can also encompass changes that are perceived by the sense of smell.” The New Hampshire court relied in part on *Gregory Packaging*.

The most recent decision on this issue is only a few months old, *Or. Shakespeare Festival Ass’n v. Great Am. Insurance Co.*, Civ. No. 1:15-cv-01932-CL (D. Or. June. 7, 2016). *Shakespeare Festival* is a first-party case in which the insured sought coverage for loss and damage to its concert venue when smoke from a nearby wildfire filled its theater, causing the insured to cancel performances and lose business income. The insured argued that it should recover because the smoke caused harm to the interior of the theater, specifically including the inside air.

The court rejected the insurer’s argument that the damage must be physical, opining that “certainly, air is not mental or emotional, nor is it theoretical.” The court relied on many of the cases discussed *supra* in concluding that a pervasive odor caused physical damage. It noted that wildfire smoke entered the interior of the theatre, making it uninhabitable and unusable for holding performances. Similar to a home tainted by methamphetamine odor as in an earlier Oregon state case, or a facility overcome with ammonia as in *Gregory Packaging*, the theater filled with smoke was “unusable for its intended purpose.” See *Farmers Insurance Co. of Or. v. Trutanich*, 123 Or. App. 6, 858 P.2d 1332, 1336 (1993) (cost of removing odor from methamphetamine lab constituted direct physical loss). The court concluded that the

theater sustained “physical loss or damage to the property” when the smoke rendered the premises unusable for its intended purpose.

Shakespeare Festival provides further insight into the classification of nondangerous odors. While methamphetamine and ammonia odors arguably provide an immediately dangerous environment for persons in close proximity, the Oregon district court did not focus on the potential danger from the smoke. Rather, the court stressed the inability to use the premises as expected as a result of the odor’s permeation of the covered property. In addition, Shakespeare Festival rejected the insurer’s argument that the smoke might fall under the pollution exclusion in the policy, holding that wildfire smoke did not fall under the exclusion because “wildfire” clearly was omitted from the policy.

Similarly, in *Pepsico Inc. v. Winterthur Int’l Am. Insurance Co.*, 788 N.Y.S.2d 142, 144 (2d Dep’t 2004), New York’s Appellate Division failed to extend the pollution exclusion beyond the exact wording of the policy, concluding that the exclusion did not apply to losses that were “non-environmental in nature.” In our hypothetical, the insurer would likely have a similarly difficult time in claiming a pollution exclusion unless the exclusion language in the policy specifically addressed the type of pervasive odor caused by the insured’s faulty workmanship. Under both Shakespeare Festival and Pepsico, a pollution exclusion defense would be unlikely to prevail.

## **Conclusion**

We again note that none of the decisions discussed herein other than Essex — the earliest, from 2009 — concerns third-party coverage, and all are from out of state. Nevertheless, pervasive odors seem to be attracting substantial coverage in the courts, so beware and use those breathing masks!

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