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Burning Down the House: How *Tidwell Enterprises* and Pyrolysis Could Affect Construction Defect Coverage

I. The *Tidwell Enterprises* Decision

A. Continuous Injury or Damage

Under California insurance law, continuous injury or damage refers to a situation where a claimant suffers injury or damage that does not occur due to a distinct event, but occurs over time. *Montrose Chemical Corp. v. Admiral Ins. Co.*, 10 Cal.4th 646 (1995). When such continuous damage spans more than one policy period, it can impact the defense and indemnity obligations of those insurers on the risk while that loss is continuing. *See, e.g., Montrose, id.; State v. Continental*, 55 Cal.4th 186 (2012). In *Tidwell Enterprises v. Financial Pacific*, 6 Cal.App.5th 100 (2016), the California Court of Appeal issued a ruling that a chemical change—called "pyrolysis"—in a chimney chase prior to a fire constituted damage sufficient to create a duty to defend. This decision, which the California Supreme Court declined to review, will have a significant impact on insurance coverage for all types of construction defect actions, not merely fire losses.

1. Water Intrusion Is Paradigm Case for Continuous Damage

The paradigm case for continuous damage is water intrusion. The allegations in such cases are predictable: the building envelope is defective such that water intrudes into the building causing water damage over time. Several trades are usually implicated for such damage, including the roofer, window installer, the framer, the stucco contractor and even the concrete subcontractor. Because no one usually can tell when the water damage commenced, the possibility exists that such damage started as soon as the building was completed.

2. Fire Damage Is Paradigm Case for Identifiable Date of Damage

The paradigm case for an occurrence on a definite date is fire damage. Under California law, the date of an "occurrence" is when the "property damage" takes place. *Remmer v. Glens Falls Indem. Co.*, 140 Cal.App.2d 84 (1956). In most fire cases, that date generally is easy to determine: the date of the fire.

Electricians are rarely sued for third-party property damage, unless their work causes a fire. As a result, they are almost never sued in continuous damage situations.

B. Facts of the Case

Tidwell Enterprises was the fireplace contactor for the construction of a new house. Tidwell installed the fireplace in 2006 or 2007. Tidwell's contract included the fabrication and installation of a custom "termination top" for the fireplace designed by the project architect, but Tidwell contended that it did not install the top on the chimney.

Financial Pacific provided general liability insurance coverage to Tidwell for the periods between March 2003 and March 2010. On November 11, 2011, 20 months after Tidwell's general liability coverage with Financial Pacific expired, the house was damaged by fire. The homeowner's property insurer, State Farm, paid for the damages. Within a few weeks, State Farm notified Tidwell about the fire and asserted that the manufacture, design or installation of the fireplace and chimney chase may have caused the fire. Tidwell immediately forwarded that letter to Financial Pacific.

Financial Pacific agreed to investigate pursuant to a reservation of rights. In January 2012, State Farm's fire expert prepared a report that the termination cap on the top of the chimney chase prevented the fireplace from drafting properly, resulting in the overheating of the fireplace and heat transfer to the adjoining wood members. In February 2012, State Farm sued Tidwell for negligently installing the fireplace system and causing the damage to the home.

Financial Pacific retained an engineer to inspect the fire scene. In May 2012, the engineer reported that Tidwell fabricated and installed the termination top and concluded that the termination top posed a fire hazard because it resulted in increased operating temperatures of the chimney.

The Financial Pacific policies provided that Financial Pacific agreed to pay sums that Tidwell became "legally obligated to pay as damages because of ... 'property damage'" caused by an "occurrence" if the "property damage" occurred during the policy period. The policies defined "occurrence" as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions." The policies further defined "property damage" as "[p]hysical injury to tangible property, including or resulting in loss of use of that property" or "[l]oss of use of tangible property that is not physically injured." In June 2012, Financial Pacific declined Tidwell's defense on the ground that the "property damage" occurred on the day of the fire November 11, 2011, after the Financial Pacific policies had expired.

Tidwell's attorney challenged the denial, claiming that the continuous burning of fires created the potential for continuous and repeated exposure to the same harmful conditions, and that damage could have been occurring prior to the final fire that burned the house. Financial Pacific continued to decline coverage because it concluded that the damages occurred on the date of the fire. Financial Pacific's position was that the "occurrence" took place on November 11, 2011, after the Financial Pacific insurance contracts had expired.

Tidwell's attorney hired an expert, who concluded that that the repeated exposure of the combustible materials framing the chimney chase to the excessive heat from every fire burned in the fireplace since it was installed "would begin [to] lower the ignition temperatures of that combustible framing." In some cases, the expert opined that the ignition point could fall below 250 degrees. The expert asserted that the structure fire would not happen in most cases with the first or a single fire, but would require a number of fires over several years since 2006 to complete pyrolysis and cause ignition. Financial Pacific continued to decline coverage on the ground that the "property damage" did not take place until after the Financial Pacific insurance contracts had expired.

II. Claims Handling

Under California law, an insurer's defense obligation is determined by the allegations in the complaint and extrinsic evidence. The questions for a claims professional handling the *Tidwell* claim is how the various allegations and extrinsic evidence affect a coverage determination.

A. Allegations in the Complaint

The complaint alleged that Tidwell's work on the chimney was defective and caused the fire for which State Farm paid damages. The complaint did not appear to contain any damage allegations other than those caused by the fire. A claims professional handling such a case likely would conclude that no damages occurred until the fire; in other words, that this fire case was typical and not like a water intrusion case.

B. State Farm's Expert Report

State Farm's expert concluded that the chimney chase was defective, resulting in the overheating of the fireplace and heat transfer to the adjoining wood members. The factual statement in the case does not state whether this heat transfer occurred over time or just the time during which the fire started. The question for the claims professional is whether this expert report provided information showing that any damage took place prior to the fire.

C. The Insured's Attorney's Opinion

In response to Financial Pacific's denial, the insured's attorney pushed back asserting that the information provided to Financial Pacific was sufficient to show that potentially covered "property damage" may have occurred during the Financial Pacific policy period. Under California law, an insurer is to take into account extrinsic evidence that could affect the insurer's coverage obligation. And while an insurer must defend an insured where the allegations in the complaint are sufficient to support any theory of recovery, the insurer does not need to assume that the plaintiff will amend his complaint to allege a covered claim. In this case, the complaint against Tidwell for was fire damage caused by the negligent installation of the termination cap on the chimney chase. The question is whether fire damage occurred prior to the actual fire. Questions for the claims professional include whether it matters how the complaint is alleged. For example, if the complaint alleged the actual date of the fire, that could affect the claims professional's decision. So, too, could allegations that the house suffered from "fire damages," as opposed to simply "damages."

D. The Pyrolysis Expert

An interesting aspect to this case is that the insured's attorney came up with a theory that damage had been occurring prior to the actual fire, and then was able to find an expert to support that theory. The insured's expert reported that each time a fire took place in the fireplace, that fire changed the chemical composition of the wood members around the chimney such that the ignition point for the wood became lower with each fire. The expert opined that the ignition point could be as low as 250 degrees, which is relatively low. (Note that the title for Ray Bradbury's dystopia, Fahrenheit 451, was based on the temperature at which books burn.) The insured's position was that this chemical change—pyrolysis—constituted potentially covered property damage.

For the claims professional, how does the expert's opinion change the landscape? Certainly, the report is extrinsic evidence that should be considered in making a coverage determination. The report indicates that potentially covered property damage occurred during the Financial Pacific policy periods. A question remains, however, whether this chemical alteration constitutes actionable "property damage" or if it is fire damage, as alleged in the complaint.

III. Effect on Indemnity Obligation

Tidwell Enterprises was a duty to defend case. The insured need only show that the complaint raised a claim for property damage potentially covered under the Financial Pacific insurance contract to give rise to that duty. The holding, however, begs the question regarding how pyrolysis could affect the insurer's duty to indemnify.

The court determined that the fire to the house was a continuous and progressive loss. California is an "all sums" jurisdiction, meaning that in a continuous loss situation, any insurer on the risk at any time during that loss is responsible for damage that occurred prior and subsequent to its policy period. The insurers on the risk can seek an equitable allocation among themselves for the damages. For example, the insurers may decide to share the indemnity obligation based on a scheme such as time-on-the-risk multiplied by limits. For most continuous loss situations, such an allocation makes sense because, for example, a water intrusion loss likely will cause damages at a steady rate over time.

In *Tidwell Enterprises*, however, there appear to be two distinct types of damage: (1) the pyrolysis-affected chimney chase; and (2) the damage caused by the actual fire. Seemingly, the damage caused by the fire could be distinguished from the damage to the chimney chase.

In a continuous loss situation, the insured generally is not supposed to pay for any gaps it may have in coverage; the insurers are supposed to pay that amount. The question is whether the *Tidwell* situation differs—or should differ—from that situation. Certainly, Financial Pacific could distinguish damage that potentially took place during its policy period to the chimney chase from fire damage that occurred after its policy period. But under the current state of the law, Financial Pacific should be obligated to indemnify Tidwell Enterprises for any damages that may be assessed against it. That means that Financial Pacific would be responsible for paying the fire damages.

IV. The Application of *Tidwell Enterprises* in Other Contexts

Now that *Tidwell Enterprises* has change how fire losses are handled, how that decision will affect other types of cases in the future will be interesting. Question will arise regarding what constitutes an "occurrence," what constitutes "property damage," and when those occur.

California law distinguishes defective construction from "property damage." *Maryland Casualty Co. v. Reeder*, 221 Cal.App.3d 961 (1998). The former is not covered, the latter is. Chances are good that creative plaintiffs and insureds will attempt to manipulate the facts to create the potential for coverage. Like the situation in *Tidwell*, such creativity most likely will arise where the insured had coverage, but not when the damage occurred or at least became manifest.

To examine how the concepts from *Tidwell* could affect other construction defect situations, we will use the following example: A framer defectively constructs a wood frame for a building. Due to the defective construction, the framing bows, but does not cause any damage to any third-party property, for example, the drywall or the exterior finishes. Within the statutory period, but after the framer's insurance had expired, the bowed framing in one wall breaks, causing damage to the drywall and the exterior finishes, and collapsing one side of the building. The building owner sues the general contractor for damages caused by the collapse. The general contractor tenders its defense to its insurer. Because the framer was among the general contractor's subcontractors, the general's insurance would also cover "property damage" to the framing.

A. Allegations in the Complaint

The allegations in the complaint are for damages caused by the collapse. Given those allegations, an insurer on the risk prior to the collapse should be able to disclaim coverage because the damages took place after the policy period.

B. Creating "Property Damage"

The insured's objective would be to secure a defense through its insurer, whose policies terminated well before the collapse. As in *Tidwell Enterprises*, the key obstacle for securing a defense would be to establish the potential for coverage during the insurer's policy period. That means that the general would need to show that "property damage" may have occurred during the policy period.

The insured hires an expert to opine that from the time the framer constructed the wood frame for the building, the frame's outward bow become worse and worse, even if imperceptibly. The expert opines that from the outset, "micro-cracks" developed on the framing members, which constituted potentially covered "property damage" during the policy period. The claims professional must determine whether *Tidwell Enterprises* changes the manner in which he or she will handle that claim. Considerations will include the pleadings and the extrinsic evidence. The claims professional must determine whether the bowing actually constitutes "property damage," keeping in mind that the insured need only show the claim can be covered, while the insured must prove that it cannot be.