July/August/September 2011

Legal Alert

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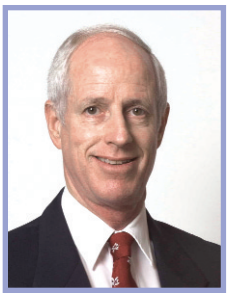
Group Builders Update – The Legislature Stirs the Pot



By Tred R. Eyerly

Our winter issue of Legal Alert addressed the impact of the Hawaii Intermediate Court of Appeals' 2010 decision in *Group Builders v. Admiral Insurance Company.* Surprisingly, *Group Builders* held that construction defects were not covered by Commercial General Liability (CGL) policies because such claims were contract based. An update on recent developments follows.

The Background: A CGL policy covers property damage caused by an "occurrence." "Occurrence" is defined as an accident. Whether construction defects arise from an occurrence or are based on breach of contract has been a hotly disputed issue across the country. In a recent trend, however, courts have found that faulty workmanship causing property damage arises from an occurrence, unless such damage is intentionally caused by the insured.

Merely establishing there is an "occurrence," however, is not the end of the analysis. If all of the policy language is considered, as required under Hawaii law, the court must consider whether any exclusions bar coverage, including the "business risk" exclusions. These exclusions preclude coverage for damage to property that must be repaired because "your work" was improperly performed. These exclusions do not apply, however, if the work was actually performed by subcontractors.

The Hawaii Supreme Court has never specifically addressed whether a CGL policy covers construction defects. Several cases, however, suggest the court would decide construction defects arise from an occurrence. For example, the seminal case of *Sentinel Ins. Co., Ltd v. First Ins. Co. of Hawaii, Ltd.* noted that the insured contractor was sued for alleged construction defects. Although the Court devoted little attention to whether there was an "occurrence," such a determination must be implied because the court held there was coverage for the property damage caused by the alleged faulty workmanship.

In two other cases, the Hawaii Supreme Court found the property damage was caused by an occurrence, and then considered whether coverage was precluded by the business risk exclusions, *Sturla Inc. v. Fireman's Fund Ins. Co.* and *Hurtig v. Terminix Wood Treating &*

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Contracting Co, Ltd. In *Hurtig*, the court found that the business risk exclusions did not negate coverage. The opposite conclusion was reached in *Sturla*. Significantly, in each case, the Hawaii Supreme Court addressed the entire policy, finding an occurrence and then turning to the business risk exclusions.

The Problem: *Group Builders* departed from this analysis when it decided construction defects are not covered under CGL policies. Instead, *Group Builders* found another line of cases persuasive. These cases hold that construction defects arise not from an occurrence, but from a breach of the construction contract, meaning there is no coverage. *Group Builders* adopted this simplistic reasoning without ever discussing the relevant Hawaii Supreme Court cases or undertaking a careful analysis of the entire policy.

The Legislature's Solution: Contractors were understandably alarmed by the *Group Builders'* decision. In addition to fighting for coverage in the courts, the construction industry sought a legislative solution.

Early in the legislative session, H.B. 924 was introduced. The final version reads, in part, "[T]he meaning of the term 'occurrence' shall be construed in accordance with the law as it existed at the time that the insurance policy was issued." A retroactive provision that the Attorney General found problematic in earlier versions was dropped from the bill. Governor Abercrombie signed the legislation on June 3, 2011.

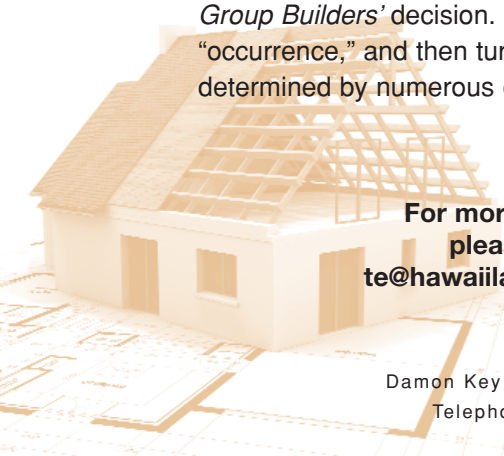
The Challenge: No court has yet ruled on the validity of H.B. 924. In cases where Damon Key attorneys represent policy holders, we will likely argue that the state of the law in Hawaii prior to *Group Builders* was as set forth in *Sentinel*, *Hurtig*, and *Sturla*.

The insurers, on the other hand, will likely argue that even the revised version of H.B. 924 is unconstitutional because it changes the meaning of the policy, thereby violating the Contract Clause. The insurers may argue a recent case issued by federal district court Judge Mollway, *HRPT Properties Trust v. Lingle*, is supportive. *HRPT* found an act passed by the Hawaii legislature to assist a specific group of lessees to the detriment of a lessor was unconstitutional under the Contract Clause. Although the articulated goal of the act, to stabilize the economy, was admirable, the act itself was not adequately designed to accomplish its purpose.

The purpose of H.B. 924 is to restore the coverage for which the construction industry paid and to ensure that the good-faith expectations of parties at the time they entered a policy are upheld. This is undoubtedly a legitimate public purpose. And arguably, H.B. 924 is designed to further this purpose. In fact, many insurers continue to advertise construction defect coverage on their websites and have units that specialize in adjusting and/or underwriting construction defect claims. Consequently, the insurers' actions have always demonstrated their intent to cover construction defects.

Since *Group Builders* was issued in May 2010, however, insurers have stampeded to state and federal courts to file lawsuits for declaratory judgments that they are no longer obligated to cover property damage arising from construction defects. H.B. 924 provides a counter argument because it restores the intention of the parties regarding what would be covered for the premiums paid by the insureds.

Even if H.B. 924 is found unconstitutional, there is still hope that the Hawaii Supreme Court will overrule the *Group Builders'* decision. The Court will be urged to analyze the entire policy, i.e., deciding whether there is an "occurrence," and then turning to the business risk exclusions. This is the analysis called for by the policy, as determined by numerous other courts.



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The Cautionary Tale of Drywall

By Christi-Anne H. Kudo Chock

As litigators, it is our job to know what laws apply to your business. While we are immensely proud of our successes at trial and have our fair share of Perry Mason stories about victorious courtroom performances (*My* favorite raconteur? Charlie Bocken, who argued and won the landmark property case, *Kaiser Aetna v. United States*, in the United States Supreme Court), proof of some of our finest work is that we never had to appear in court on a client's behalf.

Our advice? Early consultation is good business. Lest you characterize that advice as merely self-serving or trite, consider the cautionary tale of drywall.

The past decade was, in the words of Charles Dickens, the best of times and the worst of times to be in the drywall business. According to Judge Eldon E. Fallon's April 2010 decisions in *Germano, et al. v. Taishan Gypsum Co. Ltd., et al.* (Case No. 09-6687) and *Hernandez v. Knauf Gips KG*, et al. (Case No. 09-6050), the construction boom between 2000 and 2005 resulted in a shortage of building supplies. Contractors and developers turned to international suppliers to obtain the materials they needed to keep up with the growing demand for housing. Increased demand for drywall, in particular after Hurricane Katrina hit in 2005, led some suppliers, including Florida-based Banner Supply Company ("Banner"), to sell Chinese drywall manufactured by Knauf Plasterboard Tianjin Co., Ltd. (a subsidiary of the German drywall-conglomerate the Knauf Group).

Something to think about:
Unless you live or work in an airplane hangar, storage unit or warehouse, you probably are exposed to or surrounded by drywall at least once a day at home or work. An average-sized room with a 75-foot perimeter, 2 doorways (entry and closet) and 2 windows, roughly requires about 20 panels of drywall.

As early as 2006, people who owned homes constructed with tainted drywall manufactured in China began reporting noxious fumes that smelled like rotten eggs or fireworks, and that electrical wires, plumbing and ventilation systems continuously failed. Some even reported severe respiratory problems.

What Is Drywall, Anyway?
Gypsum is a soft mineral ($2H_2O \cdot CaSO_4$). It is hardened and pressed between 2 paper liners to form a panel of drywall. Naturally occurring mineral gypsum forms when a body of water slowly evaporates. Synthetic gypsum is derived from the by-products of electric power plants. Nearly half of America's electricity is produced from coal, generating about 130 million tons of waste each year. Coal-fired power plants recycle some waste through "scrubbers," or chemical reactions that can oxidize and reduce the amount of sulfur in by-products of the coal combustion process to produce flue gas desulphurization (FGD), or synthetic, gypsum. Sulfur may be present in both natural and synthetic gypsum.

By June 2009, so many lawsuits had been filed that 9 class action suits were consolidated in a Louisiana federal court. In April 2010, Judge Fallon found that health problems and property damage were tied to high concentrations of sulfur in the tainted drywall. He ordered that the defendants (manufacturers including the Knauf entities, suppliers, importer/exporters, developers, builders, contractors and installers) remove and replace *all* of the drywall, as well as appliances, cabinets, electrical wiring, flooring and plumbing, in plaintiffs' homes.

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Then, in June 2010, a Miami jury rendered a $2.4 million verdict for a Florida family whose dream home had been ruined by tainted drywall. *Armin and Lisa Seifart v. Banner Supply Co.* (Case No. 09-38337 CA 01 (42)) was the first drywall jury trial, and only one of many cases brought against Banner. The writing was on the wall. Days after documents in the Miami case had been made public by a Florida daily (including a confidential 2006 agreement between Banner and Knauf to remain quiet about tainted drywall), Banner entered into a settlement and agreed to pay $55 million to Florida homeowners. Banner then filed its own cross-claims against Knauf on July 13, 2011, asking that the manufacturer answer for its role in the drywall debacle. Based on information obtained during discovery, Banner alleges that Knauf executives knew about the sulfur and misrepresented known risks by claiming the smell was "no more than the difference between Chinese natural gypsum plasterboard and synthetic plasterboard." Banner accuses Knauf of "cowardice and calculus" since the German parent and Chinese subsidiary have claimed they are not subject to U.S. jurisdiction and that no judgment could be enforced outside of the U.S.

What about insurance?

Although the insurers in the Louisiana cases escaped liability under a "faulty materials" exclusion, a Virginia court recently ruled that damage that had resulted from tainted drywall constituted individual "occurrences" covered by a homeowner's insurance policy. *See Dragas Mgmt. Corp. v. Hanover Ins. Co.*, 2011 U.S. Dist. LEXIS 80178 (E.D. Va. July 21, 2011). Damon Key attorney, Tred R. Eyerly, follows these issues on his insurance blog, which has been recognized by LexisNexis as one of the top 50 blogs about insurance law. *See* http://www.insurancelawhawaii.com/insurance_law_hawaii/chinese-drywall/.

As more of our consumer transactions become global ones, new issues arise regarding the enforceability of contractual expectations and parties' rights in the event of a breach. Early consultation might have helped Banner understand the implications of imported drywall containing sulfur that exceeded federal and state regulations, as well as international standards for measuring environmental corrosive, or consider the ramifications of limited legal recourse against Knauf for breach of contract. Legal consultation might have led to more effective crisis control when the first shipment of drywall arrived from China, or in 2006 when Banner secretly agreed to accept Knauf's misrepresentations (without conducting its own independent testing) along with a shipment of American drywall in exchange for its silence (Banner replaced some of the tainted drywall for those who had complained but never warned its customer base).

This cautionary tale is not limited to drywall manufactured in China. At least 97 homeowners in 4 states have joined lawsuits alleging similar claims against U.S. drywall manufacturers, including National Gypsum Company (one of the largest American manufacturers of drywall made with natural and synthetic gypsum). Synthetic gypsum made from coal ash raises new considerations about what laws and regulations should apply to what we can or should do with "recycled waste." The U.S. Environmental Protection Agency announced the first-ever national rule to regulate toxic coal ash in May 2010 – well after many of the lawsuits involving American and Chinese drywall had been filed. Closer to home, a July 29, 2011, article in *Pacific Business News* reported that one of the business initiatives of newly formed Kokua Renewable Energy, Inc., a company focused on reducing waste accumulation in Hawaii, is to partner with other local organizations to recycle ash from the City and County of Honolulu's H-Power plant.

The moral of the story? Early consultation allows you to make an informed assessment of risk, and avoid or prepare for litigation in a manner that makes the most sense for your business. Let us help you ask and answer the right questions sooner rather than later.

For more information or questions regarding this article, please call Christi at 531-8031 ext 619, email her at chkc@hawaiilawyer.com, or scan the code with your smartphone.

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Christine Kubota Named Chair of the Board of the Honolulu Japanese Chamber of Commerce

We are proud to announce that one of our Directors, Christine Kubota, was named Chair of the Board of the Honolulu Japanese Chamber of Commerce (HJCC) at the largest ever Annual Generational Awards Banquet on July 9, at the Sheraton Waikiki Hotel.

Christine served as HJCC's Executive Committee Vice Chair since 2007 and will serve as Chair of the Board for the 2011-2012 fiscal year. Since joining HJCC as a member six years ago, she has significantly impacted the organization with her unwavering determination and charismatic leadership skills. As former head of HJCC's International Business Development Committee (IBD), Christine initiated an unprecedented U.S. visit from Dr. Kazuo Inamori, one of Japan's most influential businessmen and founder of Kyocera Corporation, a leading conglomerate in Japan. The forum became a landmark event for HJCC. The IBD Committee has since grown to a record of more than 60 members as a result of her efforts.

"In my many, many years as a Chamber member, I haven't seen very many others who have affected the organization so dramatically," said Wayne Ishihara, President of HJCC. "In every area of her life, she becomes a leader, on her condominium board, in her firm, in the bar association, and with our organization."

As a way to commemorate the Chamber's 111th anniversary, Christine proposed 11 challenges that will help the organization to move one big step forward into the next generation.

In addition to her new role, Christine was recently appointed as Co-Chair of the Supreme Court Committee on Court Interpreters and Language Access and confirmed as the President-Elect for the United Japanese Society. She also currently serves on the Board of the Hawaii State Bar Association and is a member of the Hawaii Immigration Lawyers Association and the Japan-America Society of Honolulu.

Born and raised in Yokohama, Japan, Christine has a deep understanding of both eastern and western culture. Her multi-cultural upbringing and bilingual abilities allow her to build relationships between the Japanese and Hawaii business communities. She is known for her innovation, high energy, and impressive ability to make a difference through her involvement in various organizations.

We commend Christine on her passion for all she does.

How Bid Protests May Affect the Cost of Rail

By Anna H. Oshiro

In our last Legal Alert, we discussed the Hawaii rail transit project. This article discusses an inevitable offshoot of the project – bid protests. Because of the size of the rail project, it was inevitable that at least some of the rail contracts would be challenged by disappointed competitors, and one is ongoing now.

This article discusses bid protest procedures as seen through the recent bid protest of the rail car provision and operation portion of the rail project.

1. **Process:** For disappointed bidders thinking about filing a bid protest, the basic process is (1) write a letter of protest to the bid officer identified in the bid documents, outlining the basics of your complaint; whereupon (2) the bid officer will issue a written decision upholding or rejecting the protest; upon which (3) the protestor decides if it wants to file a request to have the decision reviewed in an administrative hearing; after which (4) the protestor, if it lost, can choose whether to proceed with a judicial appeal. In the rail car bid protest, disappointed bidders Sumitomo and Bombardier sent protest letters to the City in April. These letter protests were officially denied at the end of June. Within days, Sumitomo had elected to proceed to the next level – administrative hearing review.

2. **Timing of initial protest:** If you are a protestor, it is essential to turn in the protest as soon as the basis for the protest becomes apparent. Protesting bidders have five (5) working days to protest after either the posting of award of contract OR when the bidder learns of facts supporting a protest. This is one of the easiest bases for quick disposal of bid protests: was this information available earlier and did the bidder sit on its rights?

   Once the procurement officer makes a decision, complainants have only seven (7) days to initiate an administrative hearing. In short, timing is essential to a successful protest. Importantly, during this initial protest, the public agency must hold off on executing a contract for and proceeding with work on a protested job. This is where potential delays to the whole of the rail project can arise out of the rail car protest. The rail car operations and production contract affects the work on the rail itself, since different rail car operators envisioned and required different tie-ins to the underlying rail construction. This means that the contract for construction of the rail will be affected by the timing of the current protest regarding the rails cars. In other words, while the current protest of the rail car contract proceeds, rail construction as a whole may be delayed. What does that mean to taxpayers? Additional cost, usually in the form of a change order negotiated between the main contractor and the public agency. How long does the letter/administrative hearing process last and can delays continue after that? The starting date for administrative hearings is set by statute, but the timing of the hearings is not set in stone.

3. **Timing of administrative hearing:** Once a public officer has answered whether the bid protest is acceptable, the bidder (in the case of rail cars, Sumitomo), has seven (7) days to file an administrative hearing request. Once that filing has occurred, the hearings officer must initiate the hearing within twenty-one (21) days. That does not mean the process will be concluded within twenty-one (21) days. The hearings officer may hold an initial hearing, and the parties may agree to put on their evidence some time thereafter. This is particularly true if the winning bidder (here, Ansaldo Honolulu) decides to intervene in the action to protect its rights. In other words, the administrative hearing can take some time. During this interim, if the award of the contract is held up or stayed (and by statute it should have been), it will likewise be stayed through the conclusion of the hearing. This means for the rail job, there will likely be additional months of delay (and costs) while the administrative hearing progresses.

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4. **After the administrative hearing:** If Sumitomo loses at the administrative hearing level, its next option will be to seek judicial review of the hearings officer's decision. By statute, the stay of the award of contract ends once the administrative hearings officer has acted. However, there is risk in moving forward with a contract while a protest is pending. If the protest appeal is successful, the court could order that the awarded contract be cancelled. In that case, the costs would be enormous. In addition to the cost of delay to the protested project, and in this case delay to the entire rail project, in such instances the previous winning bidder (in the case of rail, Ansaldo Honolulu), would be entitled to payment for its work completed to date. The costs of undoing an awarded contract are often enormous. This does not even take into account the political costs that will be suffered if the protest is successful, the monies are spent, and the job has to be rebid.

   In short, the ongoing bid protests on the rail car contracts can have huge financial impacts. It will be interesting to see how the City handles these decisions over the next few months.

   NOTE: The facts of the rail protest continue to evolve. The other disappointed rail bidder, Bombardier, filed a protest at the same time as Sumitomo, that had earlier been dismissed by the DCCA Hearings Officer. On Monday, August 15, 2011, Bombardier appealed that decision to the Circuit Court. On Saturday, August 13, 2011, the Hearings Officer issued a written decision denying Sumitomo's bid protest. Sumitomo now has ten days to decide whether to follow Bombardier's lead and appeal the hearings officer's latest decision at the Circuit Court.

For more information or questions regarding this article, please call Anna at 531-8031 ext 601, email her at aho@hawaiilawyer.com, or scan the code with your smartphone.

Mark Murakami Speaks at ABA Meeting in Portland

Real estate development in Hawaii and its unique land use laws provide interesting lessons for mainland communities trying to grapple with regional urban planning. That was the theme of Mark Murakami's presentation to the American Bar Association's State and Local Government Section meeting in Portland, Oregon in May. Mark was part of a panel on regional land use and urban planning. His presentation, entitled "Regionalized Land Use Controls: Hawaii's Statewide Zoning Model", discussed Hawaii's statutory land use regime and the Land Use Commission. Mark highlighted some of the strengths and pitfalls of statewide land use controls, as well as the Hawaii Supreme Court cases interpreting the statewide land use law. The audience included attorneys, judges, professors, and urban planners from around the country. Mark's co-presenters discussed Austin, Texas' attempts to maintain green belts and open space, Portland's transportation system, and Hillsboro's use of property tax incentives to increase economic development.

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Legal Alert is published periodically by Damon Key Leong Kupchak Hastert to inform clients of legal matters of general interest. It is not intended to provide legal advice or opinion.

Attorneys in the News

Rebecca Copeland has been appointed to be a committee member on the Access to Justice Commission's Committee on Increasing Pro Bono Legal Services.

Tred Eyerly was appointed a co-editor of the ABA's Insurance Coverage Litigation Committee's website, where insurance articles and case notes are posted. He will also be a co-presenter at a bad faith seminar in Honolulu on August 18, 2011.

Courtney Kajikawa was on a panel and spoke to the Hawaii State Bar Association Elder Law section on probate and estate planning issues for Japan-based clients on August 10th.

Greg Kugle has been asked to be a member of the Meritas Real Estate Steering Committee (composed of lawyers from U.S. firms).

Kenneth Kupchak and Retired Judge Marie N. Milks spoke on July 8th, to a UH Master's in Education Class "Educational Foundations: Leadership and Governance in Education." They discussed the role, responsibilities, obligations, expectations, etc. of trustees in private schools.

Mark Murakami has been appointed to the Board of Directors for the Good Beginnings Alliance, a non-profit trying to ensure all of Hawaii's children are safe, healthy and ready to succeed.

Robert Thomas will be speaking at the State Bar of California's 20th Anniversary Environmental Law Conference at Yosemite. Along with U.C. Berkeley law professor Joseph Sax and Deputy California Attorney General Daniel Siegel, Thomas will be speaking about "Regulatory Takings: Looking Back and Looking Forward." The Yosemite program, sponsored by the California State Bar's Environmental Law Section, is nationally recognized as the largest and most prestigious gathering in California of leaders in environmental, land use, and natural resources law.