

***Chinese Drywall Claims:
A Review of Insurance
Coverage and Liability Issues***

By

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Focused on the Business of InsuranceSM

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INTRODUCTION

During the property restoration boom that occurred in the aftermath of the hurricanes¹ that struck the southeast and Gulf coast regions of the United States from 2004 through 2008, a shortage in the availability of American manufactured gypsum board – commonly referred to as “drywall” or “plasterboard” – forced building contractors to seek alternative sources of this product. To satisfy the growing demand for this essential building material, companies began purchasing and importing drywall produced in China; a brand that is now being linked to seeping sulfide gases, allegedly causing both property damage and human health concerns. Current estimates place the quantity of drywall imported from China between 2004 and 2008 at approximately 555,000,000 pounds. It is further estimated that such drywall has been installed in upwards of 100,000 homes nationwide, primarily in the hurricane-affected states of Florida, Louisiana, and Mississippi.

With the developing body of industry and scientific evidence relating to the quality and health effects of “Chinese drywall,” it was only matter of time before litigation ensued, seeking compensation from those responsible for its importation and installation in homes across the country. As was the case with asbestos, such litigation will naturally come to bear on the insurance industry, resulting in a myriad of coverage and liability issues that will undoubtedly keep courts busy for years to come.

To assist insurance companies in better understanding the issues associated with “Chinese” drywall – from both a coverage and liability standpoint – we have prepared this report to address the types of claims that insurance companies can expect from individuals and businesses, as well as suggested actions that insurers should take when investigating, evaluating, and handling these claims.

OVERVIEW

The massive importation of Chinese drywall into the United States has been largely attributed to the enormous need for this product in the restoration and rebuilding of homes and businesses affected by the unusually high number of hurricanes that struck the United States between 2004 and 2008. Complaints relating to Chinese-manufactured drywall first emerged in July and August of 2008, primarily coming from individuals residing in and around the south Florida region. Complaints have ranged from “rotten egg-like” odors coming from the drywall, to a variety of health symptoms, including nose bleeds, respiratory problems, headaches, nausea, and skin irritation. In addition, preliminary studies suggest that the subject drywall emits a sulfur compound responsible for the corroding of electrical wiring, HVAC components, and certain household appliances in those structures that have been restored or rebuilt with Chinese-manufactured drywall.

While the cause of these problems has yet to be fully determined, the drywall at issue appears to emit gases such as carbon disulfide, carbonyl sulfide, hydrogen sulfide, and diethyl sulfide. Some have speculated that the characteristic “rotten egg” odor is a direct by-product of the presence of these chemical compounds in the drywall, and which are being found at levels and quantities exceeding those found in drywall produced in the United States.

¹ These include Hurricanes Ivan (2004), Katrina (2005) and Rita (2005).

In response to growing concerns from its homebuyers, Lennar Corp., the second-largest U.S. homebuilder, sued Knauf Plasterboard Tianjin Co., Ltd. (a major manufacturer of the drywall), along with other manufacturers, suppliers, and installers of the product, alleging that each, in its own capacity, failed to properly establish adequate quality control measures and failed to provide adequate consumer warnings. The lawsuit alleges, among other things, that the drywall is causing damage to air conditioning coils, electrical components, and plumbing fixtures in the form of a black surface accumulation. Lennar retained ENVIRON, an environmental consulting firm, to scientifically determine the cause of the damage, which led to the identification of the drywall as the source of the problem. Significantly, however, ENVIRON further indicated that the conditions created by the drywall would not result in any human health effects. ENVIRON shared its findings with various state and federal public agencies. At Lennar's request, ENVIRON continued to inspect and perform air sampling in affected homes.

In the wake of Lennar's lawsuit, numerous other actions have been brought against Knauf and other manufacturers and suppliers of Chinese-manufactured drywall. At present, several class actions have been filed in Alabama, Florida, Louisiana, Mississippi, and Ohio. Along with Knauf, defendants in these actions include Knauf GIPS KG (Knauf's parent company), Taishan Gypsum Co., Ltd., Rothchild International, Ltd. (an exporter of drywall), and several builders, installers, and distributors of the product. Individual and class litigation has also been filed on behalf of residential homeowners against manufacturers and suppliers of the drywall. In turn, manufacturers have been the target of lawsuits by construction and supply companies, seeking indemnification for the anticipated losses associated with the above claims.

In what is expected to become a growing trend, at least two homeowners have sued their insurance carrier for coverage resulting from the damage caused by the gases purportedly emitted by the drywall and an insurance carrier has filed a declaratory judgment action relying on the total pollution exclusion to preclude coverage for claims related to Chinese drywall installed in homes built by its insureds.² The litigation follows from the insurer's denial of the claims pursuant to the "Contamination" exclusion in the homeowners' policy.

The causes of action asserted by homeowners include, but are not limited to:

1. Negligence;
2. Products Liability;
3. Breach of Implied Warranty of Merchantability;
4. Breach of Implied Warranty of Habitability;
5. Fraudulent Concealment and Misrepresentation;
6. Violation of Deceptive and Unfair Trade Practices Statutes and Consumer Protection Laws;
7. Nuisance;
8. Unjust Enrichment; and
9. Breach of Contract.

² See *Baker v. American Home Assurance Company, Inc.*, 2:09-cv-188 (M.D. Fla. Complaint filed Mar. 30, 2009) and *Builders Mutual Ins. Co. v. Dragas Management Corp.*, 2:09-cv-185 (E.D. Va. Complaint filed Apr. 23, 2009).

Besides lawsuits, government officials have also become involved in the Chinese drywall issue. The Florida Department of Health, the U.S. Environmental Protection Agency, and the U.S. Consumer Product Safety Commission are all investigating complaints relating to this product. According to a Florida Department of Health Report dated March 17, 2009, based on tests conducted on three samples of U.S. drywall and one sample of Chinese drywall, there is a distinct difference between the two products. When heated and subjected to moisture, the Chinese drywall emitted strontium sulfide and other sulfuric gasses, resulting in a distinct sulfur odor. The Chinese drywall also contained a significantly greater amount of organic material (the nature of which was not established in the report) than that of its U.S. counterpart. Although the report indicated that it was inconclusive because of cross-contamination between the samples, it provided a number of potential causes of the corrosive effect of the drywall, including: 1) treatment of the drywall with an insecticide or fungicide upon entry in the U.S.; 2) sulfur chemicals used in the preparation of the paper coating; 3) contaminants in the drywall gypsum; and 4) adhesives used to bond the paper to the drywall. The report did not rule out other possible causes.

Unlike typical drywall, which is non-toxic and does not produce an atypical odor when subjected to heat and humidity, litigation involving the use of Chinese drywall alleges that it is defective because it smells like rotten eggs and emits a variety of harmful toxins that can corrode and damage metal and cause a variety of health symptoms. These toxins include: 1) carbon disulfide, a highly flammable substance used in the production of fabrics (when chlorinated, carbon disulfide becomes carbon tetrachloride, a substance cited to by health studies involving the fabric industry as the cause of nervous system effects); 2) carbonyl sulfide, which oxidizes to sulfuric acid; and 3) hydrogen sulfide, a toxic and flammable substance with an odor of rotten eggs or untreated sewage that may affect the nervous system and could cause health effects such as eye, ear, and nose irritation, as well as fatigue and headaches.

As this issue has garnered the attention of state and federal agencies (as well as the news media) and has resulted in the retention of an environmental consulting firm (ENVIRON) by a major U.S. homebuilder, we expect that the Chinese drywall issue will become more prevalent as more people become aware of its allegedly negative effects.

I. COVERAGE ISSUES

The lawsuits being filed against manufacturers, distributors, and home-builders for the alleged production, sale, or use of purportedly defective Chinese-imported drywall will result in numerous claims being filed with insurers by policyholders seeking defense and indemnification for alleged damages resulting from such production, sale, or use. Furthermore, it is anticipated that there will be numerous claims under homeowner's policies for the alleged damage to homes. Insurers are currently attempting to address the various coverage issues pertinent to these product liability-type claims. The following section discusses both first and third-party coverage issues relating to Chinese drywall.

A. First Party Issues

Parallel to the trajectory of the hurricanes striking the United States between 2004 and 2008, lawsuits alleging the inferiority of Chinese drywall are initially appearing in the Southeast and

Gulf Coast regions of the United States. While it is expected that the Chinese drywall issue will be prevalent in such states as Florida, Louisiana, and Mississippi, by virtue of the nationwide nature the building boom, lawsuits will likely also be seen across a number of other states. Recently, first-party lawsuits on this issue have been reported in Virginia. In addition, according to at least one news report, Chinese drywall lawsuits have been filed in Alabama, California, Washington, Wyoming, Arizona, and Washington, D.C.

As with all coverage matters, courts will look to the language of the insurance policy for guidance in determining whether damage due to the presence of Chinese drywall is a covered and compensable claim. In interpreting provisions of an insurance contract to determine the specific risks covered or excluded, courts utilize the ordinary rules of contract construction. Typical interpretation guidelines are:

- The policy should be construed as a whole.
- The insuring agreement is interpreted broadly and, in some jurisdictions, ambiguities are construed against the insurer.
- Exclusions and forfeitures are construed narrowly. An insured is presumed to know the contents of the policy and the intentions of the parties even though the insured did not read the policy.

When considering novel issues such as those presented by Chinese drywall coverage disputes, courts will primarily look to the intentions of the parties to help discern whether coverage is available. As this is a “new” cause of loss, in that there have not been drywall claims such as these on this scale before now, courts must first address the initial issue of whether a particular policy provision states the basic risk to be insured. Courts will also need to be educated by parties involved in Chinese drywall litigation on decisions that exemplify or demonstrate the breadth of coverage and exclusions in policies.

The first task of the first-party insurer will be to determine whether there is a covered loss; that is, is there real or personal property that has been damaged. Is there tangible property that has suffered a *loss of use*? The insurer will also need to determine if there is an “accident” with direct physical loss triggering coverage.

Determining what policy provisions apply to a loss that has not been seen before will be a difficult task for insurers. The study of the purported “off-gassing” of Chinese-imported drywall is ongoing; the science is still developing and has thus far been inconclusive. Therefore, the issue of whether the Chinese drywall is the cause of the damages alleged will be a key issue for insurers to address.

1. “Direct Physical Loss”

A threshold issue in analyzing whether coverage exists under a first-party homeowners’ insurance policy for damage to a residence caused by defective Chinese drywall is whether such damage may be deemed a “direct physical loss.” In identifying the “Perils Insured Against” by a particular policy, most homeowners’ insurance policies begin by stating that the carrier

“insure[s] against risk of direct physical loss to property described” below, subject to various coverage exclusions.

Although there are relatively few cases addressing whether construction defects such as the use of poor quality materials constitute a “direct physical loss” for purposes of coverage under a first-party homeowners’ policy, the cases that do exist suggest that construction defects would not constitute such a loss. For example, in *Whitaker v. Nationwide Mut. Fire Ins. Co.*, 115 F. Supp. 2d 612 (E.D. Va. 1999), the United States District Court for the Eastern District of Virginia held that a claim under a standard homeowners’ policy for the cost of remedying poor workmanship did not constitute a direct physical loss. As the Court explained:

[t]he language “physical loss or damage” strongly implies that there was an initial satisfactory state that was changed by some external event into an unsatisfactory state—for example, the car was undamaged before the collision dented the bumper. It would not ordinarily be thought to encompass faulty initial construction.

Whitaker, 115 F. Supp. 2d at 616 (quoting *Trinity Indus. Inc. v. Insurance Co. of North America*, 916 F.2d 267, 270-71 (5th Cir. 1990)) (internal quotation marks omitted).

Many homeowners’ policies utilize slightly more specific language, stating that the policy will provide coverage for “sudden and accidental direct physical loss.” Such language is also unlikely to provide coverage for construction defects, as demonstrated by *Tinucci v. Allstate Ins. Co.*, 487 F. Supp. 2d 1058 (D. Minn. 2007). In *Tinucci*, the United States District Court for the District of Minnesota held that under such language, no coverage was provided for water damage arising from construction defects in the residence. Noting that “all the evidence of record indicates that the water damage was caused by a variety of original construction defects present in the home since 1989,” the Court concluded that the loss was not the type of “abrupt and unexpected” loss for which coverage was provided under such policy language. *Tinucci*, 487 F. Supp. 2d at 1062.

However, a recent case has recognized that odor may constitute a physical injury for purposes of insurance coverage, albeit in the liability insurance context. In *Essex Ins. Co. v. BloomSouth Flooring Corp.*, 562 F.3d 399 (1st Cir. 2009), the United States Court of Appeals for the First Circuit examined a claim under a commercial general liability policy for installation of carpeting that purportedly emanated an odor permeating a building. The Court concluded that the allegations in the tort complaint regarding the odor stated a claim for physical injury that brought the matter within the scope of coverage on the CGL policy.

2. Exclusions

In addition to determining whether the policy encompasses loss or damage purportedly caused by Chinese drywall, insurers will need to evaluate whether particular exclusions are relevant to deny or restrict such coverage. In light of the fact that Chinese drywall claims are relatively new, whether a particular exclusion applies will need to be evaluated based on the individual circumstances of each claim.

a) Homeowners' Pollution/Contamination Exclusion

Many of the homeowners' insurance claims submitted regarding Chinese drywall will likely concern the alleged emission of hazardous gases from the drywall. Such claims may fall within the scope of a standard homeowners' pollution exclusion. A typical exclusion provides that an insurer will:

. . . not pay for loss directly or indirectly from any of the following, even if other events or happenings contributed concurrently, or any sequence to the loss:

* * * *

the discharge, disposal, release or escape of any solid, liquid, gaseous or thermal irritant, pollutant or contaminant, including smoke, vapors, soot, fumes, acids, alkalis, chemicals and waste. Waste includes materials to be recycled, reconditioned and reclaimed.

Courts will frequently interpret such policy language narrowly by requiring that insurers satisfy a high standard of proof as to whether a particular substance is in fact an "irritant, pollutant or contaminant." For example, in *Whitmore v. USAA Cas. Ins. Co.*, Civ. Act. No. 07-5162, 2008 WL 4425227 (E.D. Pa. Sep. 30, 2008), the United States District Court for the Eastern District of Pennsylvania held that a standard homeowners' pollution exclusion did not apply to the discharge of heating oil in the policyholder's basement. In reaching this conclusion, the Court held that when a pollution exclusion does not specifically identify a substance as an irritant, pollutant or contaminant, the Court must engage in an "extensive analysis" to determine whether the substance falls within any of these categories, including consideration of relevant statutes and regulations. Primarily relying upon such statutes and regulations, the Court concluded that heating oil could not be considered a pollutant unless it was released into the environment. *Whitmore*, 2008 WL 4425227 at *6.

In other jurisdictions, even evidence suggesting that a substance is an "irritant, pollutant or contaminant" may not be sufficient. For example, in *McKnight v. USAA Cas. Ins. Co.*, 871 A.2d 446 (Del. 2005), the Delaware Supreme Court held that a homeowners' policy pollution exclusion did not preclude coverage for mold or fungi. Rejecting the insurer's introduction of evidence from the Center for Disease Control regarding the hazards of mold and fungi, the Court instead concluded that as the standard pollution exclusion lists examples of substances that may be considered irritants, pollutants, or contaminants, "the insurance company is deemed to have excluded items not listed." *McKnight*, 871 A.2d at 451.

b) Water Exclusion

As many of the allegedly hazardous aspects of Chinese drywall arise when the drywall is exposed to water or humidity, many first-party homeowners' insurance claims pertaining to Chinese drywall may fall within the scope of water damage exclusions. Standard water damage exclusionary provisions stipulate that an insurer will not:

... pay for loss directly or indirectly from any of the following, even if other events or happenings contributed concurrently, or any sequence to the loss:

* * * *

by freezing, thawing, pressure or weight of water and ice, whether driven by wind or not, to a fence, pavement, patio, deck, swimming pool, foundation, retaining wall, bulkhead, pier, wharf, or dock.

* * * *

caused by constant or repeated seepage or leakage of water or steam over a period of weeks, months or years from within a plumbing, heating, air conditioning, or fire protective system, or a household appliance.

* * * *

by water damage, meaning:

- a. flood, surface water, waves, tides, tidal water or overflow of a body of water. We do not cover spray from any of these, whether or not driven by wind;
- b. water or sewage which backs up through sewers or drains or water which enters into and overflows from within a sump pump, sump pump well or any other system designed to remove subsurface water which is drained from the foundation area;
- c. water below the surface of the ground. This includes water which exerts pressure on, or flows, seeps or leaks through any part of a building or other structure, including sidewalks, driveways, foundations, pavements, patios, swimming pools, or decks.

* * * *

As both the water damage and the defects in the drywall would be contributing factors to the damage, a coverage analysis may focus upon the application of the jurisdiction's rule of "concurrent causation," which determines whether coverage is provided for a loss that was caused by both covered and non-covered perils. Many policies (such as the sample policy language quoted above) have incorporated "anti-concurrent causation" language, which

establishes that no coverage will be provided for a loss arising from both an excluded peril and a covered peril.

Recent cases have reflected the general recognition of courts that such language is valid and enforceable. For example, in *South Carolina Farm Bureau Mut. Ins. Co. v. Durham*, 671 S.E.2d 610 (S.C. 2009), the South Carolina Supreme Court recently held that anti-concurrent causation policy language precluded coverage for a loss arising from the dislodgement of a swimming pool following the draining of the pool. Due to the policyholders' failure to remove a plug in the pool's drainage system prior to draining, underground water pressure resulted in the dislodgement. The trial court determined that a policy exclusion for losses caused by "water below the surface of the ground" did not apply to the loss, as the loss resulted from the policyholders' failure to remove the plug. The Supreme Court disagreed, holding that although "the underground water pressure was not a sole cause of the loss or even the efficient proximate cause, it was a cause of the loss and so, the exclusion applies." *Durham*, 671 S.E.2d at 612.

In *Bao v. Liberty Mut. Fire Ins. Co.*, 535 F. Supp. 2d 532 (D. Md. 2008), the United States District Court for the District of Maryland analyzed whether a standard water damage exclusion applied for water intrusion into a basement that was allegedly the result of wind blowing an object into a glass door, causing it to shatter. The Court held that given the policy's standard anti-concurrent causation language, the water damage exclusion applied regardless of the role that the wind may have played in causing the loss.

c) "Inherent Vice" Exclusion

Another standard homeowners' policy exclusion that may apply to Chinese drywall claims applies to damage caused by "[m]echanical breakdown, latent defect, inherent vice, or any quality in property that causes it to damage or destroy itself." While such claims would appear to fall within the plain language of such an exclusion, courts may look with suspicion upon this argument, particularly if the injury at issue arises from the combination of defects in Chinese drywall with other causes, such as water intrusion.

For example, in *NUCO Investments, Inc. v. Hartford Fire Ins. Co.*, No. 1:02 CV 1622 CAP, 2005 WL 3307089 (N.D. Ga. Dec. 5, 2005), a commercial property insurer cited the inherent vice exclusion as a reason for denying coverage for mold damage, on the grounds that the type of wall covering used in the property, water seeping through the brick, and lack of an exhaust system all contributed to the mold growth. The Court rejected this argument, holding that "[t]he fact that numerous conditions converged to increase moisture in the walls of the hotel resulting in mold damage is simply insufficient to allow the court to conclude that each and every one of these conditions is inherent vice or latent defect." *NUCO Investments*, 2005 WL 3307089 at *6.

B. Third-Party Issues

1. CGL Policies and Construction Defects Generally

In addition to the first party issues discussed above, there will be lawsuits against businesses in the building trades, including developers, contractors, and materials suppliers, for alleged "bodily injury" and "property damage." In general, under standard Commercial General Liability ("CGL") policies, coverage for bodily injury claims is far broader than for property damage

claims. In addition, courts are usually more likely to find coverage for injured claimants than for those suffering property damage only. Suits for bodily injury will generally involve claims arising from the exposure to the noxious gasses emitted by the drywall. Property damage suits will likely include counts for breach of contract, breach of warranties, loss of use, resultant damages, and other statutory forms of relief.

Generally, CGL policies provide coverage for property damage that result from an “occurrence.” The standard CGL defines “occurrence” as an accident, including continuous or repeated exposure to substantially the same general harmful conditions. The classic test to determine whether or not there is an “occurrence” involving defective work under a CGL policy is whether the property damage is unexpected and unintended, and whether it extends beyond the work or product of the insured.

However, different jurisdictions apply different tests to determine what constitutes an “occurrence” in the construction defect context. In some jurisdictions, a construction defect is never an “occurrence” because it lacks the element of fortuity. However, in other jurisdictions, while the damaged work itself may not be covered, the damage that results therefrom is considered an “occurrence.” For example, where a sub-contractor installs windows improperly, resulting in leaks, a typical CGL policy will not cover the repair or replacement of the windows, while the cost of replacing the carpet will fall within the ambit of coverage. Accordingly, while most states recognize that the purpose of the coverage provided by the CGL policy does not extend to the risk of repairing or replacing the insured’s own defective work, individual factual scenarios are rarely that simple.

Another threshold issue in analyzing coverage for construction defects under a CGL policy is determining when coverage is triggered. Again, different jurisdictions address this inquiry in different ways. Thus, depending on applicable law, the trigger of coverage could be: 1) when the drywall was installed in the home; 2) when the homeowner began to notice the damage or corrosion in the home; or 3) a continuous trigger, so that all policies that are in effect while the damage is “ongoing” are triggered.

Compounding this inquiry in the context of Chinese drywall claims is the fact that the “defect” may be latent for a period of time before causing any property damage. While applicable statutes of limitations or policy limitations of liability provisions may serve to limit one’s ability to assert a viable claim, it is important to remember that these are not defenses to coverage.

2. Trigger of Coverage

Theoretically, the happening of an “occurrence,” as defined in the policy, triggers coverage under an occurrence-type policy. In some jurisdictions, an “occurrence” takes place at the time of the wrongful act that causes the property damage or injury. In other jurisdictions, however, an “occurrence” takes place at the time the claimant was injured or the property in question was damaged. Thus, the date of the actual “wrongdoing” may be irrelevant.

Of course, a policy can be worded in such a manner as to expressly make the trigger of coverage the date of the wrongdoing. In that event, if the wrongdoing takes place during the policy period, all subsequent injury or damage after the policy expires may also be covered.

One recurring issue in the context of determining the trigger of coverage is whether damage takes place immediately upon the installation or incorporation of a defective product into a larger product, or whether damage takes place when there is resultant physical injury to, or loss of use of, tangible property. Most courts have adopted the former alternative. The argument in favor of the latter is that the mere incorporation of a defective product (one that has not yet deteriorated or malfunctioned) into something else, does not automatically constitute property damage to the larger product since there is no fortuitous damage.

Another recurring issue that arises in the context of determining the trigger of coverage is ascertaining the date of injury or damage (hereinafter, collectively referred to “injury,” but encompasses both bodily injury and property damage) in those instances involving an ongoing and continuing injury that was latent for a period of time. The rule in the majority of the courts is that coverage is triggered from the date of the first latent injury, and continues to be triggered at least until the date the injury first manifests itself. Since coverage is triggered in the event of an injury during the policy period, the foregoing rule merely comports with the express terms of common or typical policy language, and does not impute an “awareness” requirement into such language where none exists.

The Court’s analysis in *St. Paul Fire & Marine Insurance Co v McCormick & Baxter Creosoting Co.*, 870 P.2d 260 (Or. Ct. App. Mar. 9, 1994), is illustrative:

Our analysis of the trigger of coverage issue does not require going beyond the plain meaning of the policies, which provide for damages for injury or destruction of property *during* the policy period. The policies do not make damages dependent on a time of discovery. Insurers argue, however, that the manifestation theory is the only reasonable one because [the insured’s] interpretation ignores that the policies limit coverage to “occurrences” or “accidents” that *result in* property damage *during* the policy period. Their argument is not that the terms of the policy are ambiguous but, rather, that there is no property damage unless it is known. However, insurers point to no language in the policies that say that damage comes into existence at the time that it becomes known. Their interpretation would require us to go outside the text of the policy, and we do not conclude that the ordinary purchaser of insurance would understand “damages” to have the philosophic underpinnings urged by insurers...

Under the plain language, all that is required to trigger coverage is damage to property *during* the policy period.

McCormick & Baxter, 870 P.2d at 264-65.

Applying the foregoing rule, when there is ongoing property damage or bodily injury, every policy in effect during the ongoing damage or injury will provide coverage. The burden should be on the insured to prove that there was, in fact, such injury during the policy period. The insured should also have the burden of quantifying such injury, unless: 1) the issue is how to allocate the injury among policies covering consecutive policy periods, or 2) quantification is impossible.

The foregoing discussion assumes that there was ongoing injury during the policy period. In some cases, although the damage was not corrected over the period of multiple policies, there was no new damage after the initial policy period. That is, the damage that took place during the initial policy period did not worsen. In that event, only the initial policy should afford coverage.

Furthermore, there have been other modifications to the general rule that the date of first damage is the date that coverage is triggered. The rule adopted by some courts is that no coverage can be triggered prior to the date that the *complainant* came to own the property. For example, insurers often argue that the proper inquiry under these policies is not whether property *damage* occurred during the policy period, but whether the entity making the claim sustained *harm* during the policy period.

Surprisingly, inconsistent with the foregoing, some courts have also held that there is no injury—and, therefore, no coverage triggered—until the injury has become manifest or discoverable. Other courts have held that although the trigger of coverage for bodily injury claims is the date of latent injury, the trigger of coverage for property damage claims is the date of the manifestation of the damage.

Finally, the trigger of coverage should not be confused with the scope of coverage. Under a standard occurrence-type policy, once damage or injury triggers coverage during the policy period, all consequential damages are covered, regardless of whether such damages occur during the policy period.

As claims relating to the use of Chinese drywall continue to develop, it appears likely that they will arise from continuous exposure to harmful toxins. As a result, the trigger of coverage will be similar to that developed in asbestos and pollution coverage litigation. However, it is worth noting that the date of installation will be readily identifiable, and as such, in those states that look to the date when the defective product was installed, there might be a strong argument that only the policy covering that date should apply.

3. Potential Exclusions

There are several standard CGL policy exclusions that may serve as a bar to coverage in Chinese drywall cases, the application of which will depend on the circumstances surrounding the claim and the law of the jurisdiction in which the claim arises. When damage results from several different causes, some of which are covered by the policy and some of which are not, the insurer will be required to defend the insured. Furthermore, when such a conflict exists, the insurer may be required to pay for counsel of the insured's choosing. Finally, if the damage is indivisible by cause, the insurer may be liable to indemnify the insured for the entire loss.

a) "Pollution" Exclusion

The impact of the pollution exclusion will depend on how the specific jurisdiction treats this exclusion. In large part, the exclusion has been limited to "traditional environmental claims." The construction defect claims regarding Chinese drywall may likely be considered a "non-environmental" claim. Nevertheless, as discussed below, the precise contours of the exclusion vary from state-to-state and should be carefully monitored and considered in each jurisdiction.

Insurers will likely argue that claims under a commercial general liability insurance policy pertaining to the use of Chinese drywall fall within exclusionary provisions typically referred to as “total” or “absolute pollution exclusions.”³ For purposes of such an exclusion, the term “pollutants” is typically defined as “any solid, liquid, gaseous or thermal irritant or contaminant, including smoke, vapor, soot, fumes, acids, alkalis, chemicals, and waste. Waste includes materials to be recycled, reconditioned or reclaimed.”

In interpreting such policy language, courts in recent years have often examined whether the exclusion should be limited in scope to pollution that is released into the environment. The most recent major decision to discuss this issue is *Noble Energy, Inc. v. Bituminous Cas. Co.*, 529 F.3d 642 (5th Cir. 2008), in which a liability insurer invoked a standard pollution exclusion to preclude coverage for a truck explosion that was allegedly due to vapors emanating from items placed in the truck. The Court rejected the claimant’s contention that the pollution exclusion should be limited to claims for pollution released into the environment, instead holding that “a pollution exclusion clause applies whenever a pollutant causes harm by a physical mechanism enumerated in the policy, irrespective of where the injury took place or whether the pollutant was released into the environment.” *Noble*, 529 F.3d at 649.

As noted above, courts have also focused on whether the item at issue may be considered a “pollutant” for purposes of applying the exclusion. One such example is *Reed v. Auto-Owners Ins. Co.*, 667 S.E.2d 90 (Ga. 2008), wherein the Georgia Supreme Court examined whether a standard pollution exclusion applied to a claim for the release of carbon monoxide at a residence, allegedly causing injury to the individual renting the house. Contrary to the fact-intensive approach applied by jurisdictions such as Pennsylvania (as set forth above), the Court concluded that it “need not consult a plethora of dictionaries or statutes to conclude that” carbon monoxide was a pollutant for purposes of the exclusionary clause, given the claimant’s allegations that she was “poisoned” by the carbon monoxide, thereby resulting in bodily injury. *Reed*, 667 S.E.2d at 92. As in *Noble*, the Court also considered the contention that the pollution exclusion should be limited in scope to environmental pollution. The Court rejected this contention on the grounds that it was unsupported by the policy language at issue. *Id.*

The question of whether a particular substance could be deemed a “pollutant” was also at issue in *Whittier Properties, Inc. v. Alaska Nat. Ins. Co.*, 185 P.3d 84 (Alaska 2008), which concerned whether a standard pollution exclusion precluded coverage for liability claims against the policyholder arising from the leakage of petroleum from an underground tank. Rejecting the policyholder’s contention that the policy was ambiguous as to whether petroleum should be considered a pollutant for purposes of the exclusion, the Court held that “when [] gasoline escapes or reaches a location where it is no longer a useful product, it is fairly considered a pollutant.” *Whittier Properties*, 185 P.3d at 91.

Courts have also considered whether a fact pattern pertains to the “discharge, dispersal, seepage, migration, release or escape” of pollutants for purposes of applying the pollution exclusion. Such an issue was recently addressed by a California appellate court in *Johnson v. Clarendon Nat. Ins. Co.*, No. G039659, 2009 WL 252619 (Cal. Ct. App. 4 Dist. Feb. 4, 2009), which involved a

³ The primary difference between a “total” and “absolute” pollution exclusion is that a “total” pollution exclusion contains an exception to the exclusion for pollution arising from certain types of fires.

commercial general liability claim arising from a policyholder landlord's alleged negligence in permitting water intrusion and subsequent mold growth in a residence. In holding that the pollution exclusion did not pertain to the claim, the Court opined that the "negligent maintenance of the structure resulting in water intrusion does not sound remotely similar to the 'discharge, dispersal, release or escape' of a pollutant." *Johnson*, 2009 WL 252619 at *11.

A contrary result was reached by the United States District Court for the Western District of Missouri in *American Western Home Ins. Co. v. Utopia Acquisition L.P.*, No. 08-0419-CV-W-ODS, 2009 WL 792483 (W.D. Mo. Mar. 24, 2009). As in *Johnson*, the *Utopia* case concerned a commercial general liability claim arising from the alleged infestation of an apartment from mold, "serious moisture," and other airborne contaminants. While the policyholder acknowledged that coverage for the allegations of mold infestation was barred by a mold exclusion, the policyholder contended that the policy provided coverage for the claims pertaining to moisture and contaminants. The Court disagreed, noting that the policy specifically defined the term "pollutants" (as used in a standard pollution exclusion) to include contaminants. The Court also concluded, without detailed analysis, that policy language precluding coverage for the "discharge, dispersal, seepage, migration, release or escape" of a pollutant "encompass[ed] mold and other airborne contaminates that are discharged, dispersed or released into the air before being ingested or inhaled." *Utopia*, 2009 WL 792483 at *3.

b) "Fungi, Mold and Bacteria" Exclusion

The mold, fungi and bacteria exclusion (hereinafter mold exclusion) excludes coverage for bodily injury or property damage relating to the inhalation, ingestion or exposure to fungi, mold or bacteria within a building. There is some disagreement between states regarding whether or not the mold exclusion applies if the mold growth is traceable to another covered risk.

For example, in *Empire Indemnity Ins. Co. v. Winsett*, 2009 WL 1178516 (C.A. 11 (Fla.)), the Eleventh Circuit Court of Appeals analyzed the mold exclusion contained in a CGL policy. It appeared that the mold growth was a product of the builder's failure to install a vapor barrier. The Court, applying Florida law, found that even if the mold growth was caused by a covered preceding event, the clear and unambiguous meaning of the language of the exclusion nevertheless barred coverage for the claim.

Based on the current science regarding the potential "injuries" caused by exposure to the defective Chinese drywall," it appears that this particular exclusion will not apply. While there is some organic matter involved, the damages seem to result from the inhalation of toxic chemicals, not the microorganisms set-forth in the mold exclusion. Nevertheless, these factual developments and the science associated with Chinese drywall should be monitored closely to determine whether or not the mold exclusion will limit an insurer's exposure.

c) "Expected or Intended" Exclusion

It is doubtful that the exclusion for injuries "expected or intended from the standpoint of the insured" will be applicable to Chinese drywall claims.

The applicability of this exclusion turns on whether or not the insured "expected or intended" the injury. Some states use an objective standard, while others employ more subjective standards.

The objective standard focuses on whether a reasonable insured should have known that damage or injury would result from the insured's conduct. In contrast, there is some authority suggesting that the subjective standard requires evidence that the insured actually expected or intended the consequent damage or injury.

Clearly, however, there will be allegations that the contractor "knew" that substandard drywall was being installed. While the contractor may have intended the installation, the "injury" would not have necessarily been intended, the presentation of evidence to the contrary should nevertheless be anticipated, and in certain instances, expected. It appears unlikely, however, that this exclusion will prove successful in the context of Chinese drywall claims.

In addition, the "expected or intended" exclusion bars coverage for "bodily injury" or "property damage" that is expected or intended from the standpoint of the *insured*. If the insured was aware that the drywall could be expected to cause damage, this provision could apply. Therefore, questions pertaining to the installer's knowledge that the drywall was from China, as well as the installer's knowledge of the potential hazards of the drywall, must be considered in the analysis of whether or not to honor a claim.

Courts have typically recognized that this exclusion applies only to intentional conduct by the policyholder, rather than negligent (or even grossly negligent) conduct. For example, in *Delta Pine & Seed Co. v. Nationwide Agribusiness Ins. Co.*, 530 F.3d 395 (5th Cir. 2008), the United States Court of Appeals for the Fifth Circuit held that the "expected or intended" exclusion did not apply to a claim under a commercial general liability policy for defense and indemnification of a lawsuit pertaining to the negligent blending of old and new crop seeds sold by the policyholder. The Court determined that the underlying tort action did not allege "damages resulting from an intentional injury." *Delta Pine & Seed*, 530 F.3d at 402. As such, the exclusion may not apply in the context of a Chinese drywall claim where the insured intended to install sub-standard drywall, but did not intend to cause corrosion of the electrical components of the home's HVAC system. Under these circumstances, it may be difficult for an insurer to disclaim coverage using this exclusion.

d) "Faulty Workmanship" Exclusion

A significant amount of case law pertaining to the various versions of the "faulty workmanship" exclusionary language focuses on the "ensuing loss" exception. In *Rosenberg v. First State Insurance Co.*, 280 Cal. Rptr. 388 (Cal. Ct. App. Apr. 29, 1991) (review denied and ordered not to be officially published (Aug. 15, 1991)), completion of the insured's commercial structure was delayed as a result of a problem arising during the course of construction. In particular, the shoring used when pouring the concrete in the subterranean garage was removed prematurely, which resulted in the deflection of the first floor and parking level, the development of cracks, and the accumulation of water. The builder's risk policy contained a faulty workmanship exclusion that provided: "This policy does not cover: ... the cost of making good faulty or defective workmanship, material, construction, or design, but this exclusion shall not apply to damage resulting from such faulty or defective workmanship, material, construction, or design."

Relying on the policy's faulty workmanship exclusion, the insurer denied the claim for economic damages, including lost rents, which were incurred as a result of the need to repair the structure.

The trial court granted judgment in favor of the insurer, but the appellate court reversed. The Court analyzed the policy's insuring clause, which required the existence of "physical loss." The Court found that the complaint contained allegations of cracking and unlevelled concrete floors, which provided a record of physical damage sustained by the structure.

The Court then proceeded to analyze the faulty workmanship exclusion:

Defendant urges that "faulty workmanship is ... not a covered peril" and, accordingly, the policy provides no coverage for loss of rents resulting from such faulty workmanship. We disagree. The policy's exclusion of coverage for the cost of "making good" faulty workmanship does not establish that faulty workmanship is not a covered peril. To the contrary, the phrase stating this exclusion goes on to clarify that "this exclusion does not apply to damage resulting from such faulty or defective workmanship, material, construction, or design." Because damage resulting from defective workmanship is expressly covered by the policy, the conclusion is inescapable that faulty workmanship is a covered peril.

Rosenberg, 280 Cal. Rptr. at 392. Furthermore, the Court found coverage for the consequential damages (*i.e.*, the lost rents), in addition to the costs associated with the repair of the physical damage:

The rule ... is that the insurer, while not liable for repair or replacement of the contractor's defective work or product, is nonetheless liable for damages to other property caused by the defects ... We conclude that the phrase in the contract of insurance, "this exclusion shall not apply to damage resulting from such faulty or defective workmanship, material, construction, or design," encompasses economic damages resulting from defective workmanship as well as physical damage.

Rosenberg, 280 Cal. Rptr. at 392-93 (citations and internal quotation marks omitted).

e) "Defective Design" Exclusion

Closely-related to the "faulty workmanship exclusion" is the exclusion for "defective design." What constitutes "defective design" can be problematic, as it can be difficult to prove whether a manufacturer deviated from some design protocol in the creation of the product. It is likewise difficult to establish that the drywall was a "flawed product," since it had already been installed at the time of the accident.

The result of the above case law regarding issues of faulty workmanship and/or defective design generally leaves insurers in the unenviable position of trying to predict whether or not courts will find these exclusions applicable to the "defective" drywall.

f) "Contractual Liability" Exclusion

The Contractual Liability Exclusion has been viewed by many courts to support the fact that one of the purposes of a CGL policy is to cover *unforeseen* risks... While it may be clear that the

CGL policy will not apply to breach of contract actions against the insured, the above exclusion contains an exception for agreements by which the insured assumes the tort liability of another.

While it may be clear that the CGL policy will not apply to breach of contract actions against the insured or broad agreements to indemnify another, there is an important exception for agreements by which the insured assumes the tort liability of another as part of a business contract. Courts will interpret these “insured contract” provisions broadly, in favor of coverage, and may include the indemnified party’s legal fees. *See Golden Eagle Ins. Co. v. Insurance Co. of the West*, 99 Cal. App. 4th 837, (pursuant to the “insured contract” the insurer is responsible for the all sums, including the indemnified party’s legal fees, for which the insured is liable by the terms of the indemnification agreement).

In analyzing these situations, review of the indemnity provision in the “insured contract” is crucial to determine the scope of the coverage. As stated by the California Court of Appeals, “construction defect litigation is typically complex and expensive” and in many instances the defense costs may exceed the cost of the loss several times over. *Id. at 852.*

g) “Your Work” Exclusion

This exclusion bars coverage for damage to “your work” and is included within the products-completed operations hazard. The definition of “Your Work” includes materials, parts or equipment furnished as part of the work. The “Products-Completed Operation Hazard” is defined as “All bodily injury and property damage occurring away from premises you own or rent and arising out of your product or your work except: 1) products that are still in your physical possession; and 2) work that has not yet been completed or abandoned.”

An important exemption to this exclusion effectively returns or “hands back” coverage to the insured for damage arising from work performed on behalf of the insured by a sub-contractor. So long as the property damage arises out of a lower-tier contractor’s work, materials, or design, the “Your Work” exclusion will not bar coverage for suits against an insured contractor. As such, there may be instances where a general contractor could be covered for damage to the building as a whole by virtue of the fact that the defective drywall was installed by a subcontractor. To determine whether coverage applies to a Chinese drywall claim in light of this exclusion, a review of the status of the insured and the relationship between the insured and other parties (*e.g.* general contractor, sub-contractor, or installer) would need to be conducted.

h) “Work Product” Exclusion

The “Work Product” exclusion precludes coverage for property damage to the insured’s “products” arising out of those very products or a portion thereof. The question of whether a building is a “product” is often times subject to debate; although some courts apply the exclusion to preclude coverage on the basis that a CGL policy does not provide coverage for faulty workmanship. Again, the application of this exclusion will depend on the jurisdiction in which it is asserted.

i) “Sistership” Exclusion

The “Sistership” or “Product Recall” exclusion bars claims for expenses associated with the repair or replacement of a product when it has been withdrawn from the market. Thus, if the insured is a distributor of building materials, this exclusion is of particular importance. It should be noted, however, that the exclusion does not exclude coverage for the actual damage caused by the product itself. *See, e.g. Centillum Communications, Inc. v. Atlantic Mutual Insurance Co.*, 528 F. Supp. 2d 940 (N.D. Cal. 2007).

In light of the resolution introduced in the U.S. Senate seeking to impose a recall of all Chinese drywall, this exclusion may serve to bar claims associated with such a recall.⁴ However, the Sistership exclusion will not function to bar claims relating to the repair, removal and/or replacement of defective drywall if there is no general recall. *See e.g. Standard Fire Ins. Co. v. Cheter O’Donley & Associates, Inc.*, 972 S.W. 2d 1 (Tenn. Ct. App.), appeal denied (July 6, 1999).

j) “Premises Alienated and Owned” Exclusion

This exclusion applies to coverage for damage to property sold by an insured. There is a split in authority as to whether or not the exclusion applies to situations where a contractor buys land and develops it without occupying the premises for its own use. *See e.g. Prudential – LMI Commercial Ins. Co. v. Reliance Ins. Co.*, 22 Cal. App. 4th 1508 (1994), *McKellar Development of Nevada, Inc. v. Northern Ins. Co. of New York*, 108 Nev. 729 (1992) *Fejes v. Alaska Ins. Co.*, Inc., 984 P.2d 519 (Alaska 1999) (the exclusion would limit the coverage provided by the completed work endorsement). *See contra American States Ins. Co. v. Hanson Indus.*, 873 F. Supp. 17, (S.D. Tex 1995); *Reliance Ins. Co. v. Povia-Ballantine Corp.*, 738 F. Supp. 523 (S.D. Ga. 1990) *aff’d* 927 F.2d 614 (11th Cir. 1991). Some courts have noted that the exclusion does not apply to work performed by subcontractors. *See e.g. McKellar Development, supra*.

k) “Impaired Property” Exclusion

The “Impaired Property” exclusion bars coverage for economic loss to an insured arising from damage to another’s property, which was in turn caused by the insured’s own faulty workmanship in the overall construction project. The exclusion requires that the damaged property is capable of being repaired.

⁴ Senate Resolution 91, which was introduced on March 30, 2009, calls on the Consumer Product Safety Commission, the Secretary of the Treasury, and the Secretary of Housing and Urban Development to take action on issues relating to drywall imported from China. The resolution asks the Consumer Product Safety Commission to: 1) initiate a formal proceeding to investigate drywall imported from China during the period from 2004 through 2007; 2) prohibit the further importation of drywall and associated building products from China; 3) order a recall of hazardous Chinese drywall; and 4) seek civil penalties against the drywall manufacturers in China that produced or distributed hazardous drywall and their subsidiaries in the United States to cover the cost of the recall effort and other associated remediation efforts. The Resolution also asks the Secretary of the Treasury and the Secretary of Housing and Urban Development to use all available measures, including civil forfeiture authority, to ensure that the costs of homeowner assistance are borne by the Chinese manufacturers (and their U.S. subsidiaries) of the drywall, not by the taxpayers of the United States. The Resolution also seeks to have these agencies develop meaningful Federal tax incentives to help offset the expense of costly drywall repairs for struggling homeowners. Similarly, bills were introduced in the House and Senate (H.R. 1977 and S. 739) seeking a ban on the importation of Chinese drywall and to study its effects. These bills, however, do not seek a recall of the drywall.

Given the plain language of this exclusion, a primary consideration in determining whether a loss falls within this exclusion is whether the damage alleged to have arisen from the “impaired property” may be rectified by repairing or replacing the policyholder’s work. This consideration was at issue in *Essex Ins. Co. v. BloomSouth Flooring Corp.*, *supra*, which (as noted above) concerned a liability claim for installation of carpeting that purportedly emitted an odor permeating a building. As the underlying Complaint did not contend that the odor could be remediated simply by replacing the carpet, but rather, alleged that the injured party was forced to install air filters in an effort to remediate the odor, the First Circuit Court of Appeals held that in light of these allegations, the claim did not fall within the “impaired property” exclusion.

A similar analysis was applied in *McGranahan v. Insurance Co. of New York*, No. Civ. 2:07-0065 FCD KJM, 2008 WL 4850751 (E.D. Cal. Nov. 10, 2008), which concerned a demand for indemnification under a commercial general liability policy for an arbitration award pertaining to mold-infested drywall. The Court held that such a claim did not fall within the “impaired property” exclusion, given the determination by the arbitrator that replacement of the drywall would not only have failed to ameliorate the mold problem, but could have exacerbated the problem by releasing mold spores in the air. *McGranahan*, 2008 WL 4850751 at *8.

This exclusion could apply where an insured subcontractor seeks coverage for incurring the cost of the removal and repair of the Chinese drywall the subcontractor installed after it has caused damage to the home.

4. Other Issues

Liability insurance policies typically state an aggregate limit of liability that applies, if not to the entire policy, at least to certain designated coverages. The aggregate dollar liability represents the insurer’s maximum total dollar liability, and would be applicable to Chinese drywall-related losses.

a) Products Completed Operations Hazard

Liability policies often contain either an exclusion for injury or a separate policy limit for claims encompassed by the Completed Operations Hazard exclusion. The standard policy definition of this exclusion has been interpreted narrowly. It has been held that the standard definition applies only to construction or maintenance type work. Commentators appear to be in agreement that this exclusion refers to accidents caused by defective workmanship that arises after the completion of work by the insured on construction or service contracts. Moreover, the fact that servicing of an otherwise completed system remains to be done, or that some aspect of the job was unwittingly not done, does not render the operation incomplete. Work is complete when those involved with performing and receiving the work believed that the work was complete. Similarly, it has been held that an insured’s work is complete when an insured abandons the work, even if the project remains unfinished.

Typically, Completed Operations Hazard exclusions also include a “Products-Completed Operations Hazard” exclusion. Specifically, a policy will provide that there is no coverage for bodily injury or property damage included within this exclusion with insurers defining the term “Products-Completed Operations Hazard” to include — subject to a few provisos — all injury

“occurring away from premises you own or rent and arising out of your product.” Such exclusions are often written broadly enough to eliminate coverage for more than product liability claims.

Despite the exclusionary language, there are certain requirements that must be met for a bodily injury claim to be covered by the “Completed Operations Hazard” and the “Products-Completed Operations Hazard.”

b) Number of Occurrences/Aggregates

In handling Chinese drywall claims, there will certainly be issues regarding the number of occurrences and the impact upon policy aggregates. Each installation could be a separate occurrence, although insurers may also want to argue that each “grouping” of installations based on a single “batch” of drywall constitutes a single occurrence. Ultimately, the issue of what constitutes an “occurrence” may very likely be left to the courts to decide.

Of course, the number of occurrences is an issue separate and distinct from the question of whether there has been an occurrence within the meaning of the policy. Whether deemed one occurrence or multiple injuries from a single act or series of related acts can impact the applicability and effect of deductibles under the same circumstances.

Although courts have employed a number of approaches to this issue, courts in most jurisdictions look to the cause or causes of the injury or damage and not to the number of manifestations of injury or damage to determine the number of occurrences. In a minority of jurisdictions, the courts look to the effects of the causative acts to determine the number of occurrences.

5. Common CGL Endorsements that May Limit Coverage

In addition to the common exclusions contained in many CGL policies, policies issued to businesses in the building trade often contain the following endorsements that may serve to limit an insurer’s exposure to Chinese drywall claims.

a) Known or Continuous Injury or Damage

This endorsement prevents coverage for losses of which the insured is aware prior to the policy inception date. Again, the insured’s knowledge of the defective nature of the drywall is an issue. This endorsement will be important in claims that may arise from later construction. An insured cannot insure against something that has already begun and which is known to have begun. The endorsement included in most policies solidifies the “fortuity doctrine;” that is, the policies are to preclude coverage for two categories of losses: (1) known losses; and (2) losses in progress. Since applying the doctrine to a claims-made policy will not preclude coverage for losses of which the insured is not aware of at the policy’s inception, the fortuity doctrine does not render claims-made insurance illusory, but merely restricts coverage to unknown losses. As such, the applicability of this endorsement/doctrine is fact-sensitive and subject to an insured’s subjective and individual knowledge regarding problems associated with Chinese drywall.

b) “Damage to Work Performed by Subcontractors on Your Behalf” Exclusion

This endorsement limits coverage for work performed by subcontractors. Therefore, where a general contractor originally could have received coverage for the installation of defective drywall by a subcontractor, this endorsement would remove that coverage. This endorsement, if applied in a straight forward manner, should reduce an insurer’s exposure for claims against the insured’s general contractor, especially if the sub-contractor responsible for the installation of the drywall controlled the selection of the building products at issue.

In light of the numerous exclusions and other limitations in endorsements affecting CGL policies, drywall claims will likely come at insurers under various submissions. With science incomplete, reservations of rights will be prevalent insofar as insureds will presumably be seeking coverage under all sections of their policy. Insurers will be wise to review these exclusions and endorsements now to be ready for all of these coverage issues.

C. Other Potential Coverage Issues

1. Notice – What Does the Policy Require?

In the absence of an applicable statute, an insured’s unexcused failure to give timely notice may result in a loss of benefits. There is a split of authority as to whether such failure, in and of itself, is sufficient to invalidate coverage. One line of case law holds that timely notice is a condition precedent to coverage and that, as a result, an unexcused delay in giving notice, as required by the policy, will necessarily result in a loss of coverage. A few states appear to have adopted this rule by statute. Even in states adopting such a rule, an unexcused delay in providing notice to an insurer may not forfeit coverage unless the insurer can establish that it was prejudiced by the delay.

The second line of authority holds that late notice will eliminate coverage unless the insured can demonstrate that the insurance company was not prejudiced by the late notification. These courts reason that, due to the difficulty of an insurance company affirmatively proving prejudice as a result of an insured’s failure to comply with the notice requirements, such prejudice should be presumed, leaving it to the insured to rebut the presumption.

The third line of authority holds that an unexcused failure to give timely notice cannot result in a loss of coverage unless the insurer can demonstrate that it has been prejudiced by the delay. These courts reason that the notice provision is designed to preserve the insurer’s ability to defend the claim effectively and that, as a result, no good reason exists to allow the insurer to escape its liability when it cannot show it was prejudiced by the lack of timely notice. This latter rule is followed in the majority of states and continues to gain wider acceptance. However, the rule creates substantial challenges for the insurance industry since, as a practical matter, it is often difficult for an insurer to affirmatively prove that it was prejudiced by an insured’s untimely notice of a claim.

2. Statutes of Limitation/Statutes of Repose

Dovetailing with the trigger issues discussed earlier, it will be useful for insurers to ascertain when they can reasonably expect to be free from liability for Chinese drywall claims. Statutes of Limitations throughout the country typically range from four to six years for breach of contract, although Ohio and Kentucky have 15-year statutes. The Statute of Limitations, in some jurisdictions, will begin to run from the date that the plaintiff discovers the defect or damage. In other jurisdictions, the Statute of Limitations begins to run from the date the damage or injury actually occurred.

Statutes of Repose, another limitation on liability, impose a bar on suits for defective construction after a certain period from, for example, the date of completion, the date that the owner takes possession of the building, or the date of the certificate of occupancy is issued. Thus, the discovery of the defect may be irrelevant. For a more detailed discussion of Statutes of Repose, see Section V.B.1., below.

Furthermore, some policies contain specific time related limitations on actions. Therefore, those limitations clauses in individual policies should be reviewed for applicability. It should be noted, however, that while these limitations on liability may serve to limit an insurer's actual liability costs, they are typically not a defense to coverage.

3. Bad Faith/Extra-Contractual Payments

Parties seeking coverage for losses purportedly caused by Chinese drywall will undoubtedly allege that any denial of such coverage was unreasonable and made in bad faith. Insurance carriers that are alleged to have engaged in such conduct will be placed in the position of defending their actions by asserting the reasonableness and propriety of their course of conduct. Given various issues of causation and the uncertain and new nature of Chinese drywall claims, carriers may have some latitude in their investigation, but should remain cognizant that significant delays in handling these claims may provide additional evidence of bad faith.

Examples of vexatious and unreasonable conduct on the part of the insurer include:

1. Refusing to pay a claim, despite knowledge that it was liable and knowledge that refusal would result in serious damage to the insured;
2. Failing to adequately investigate a claim;
3. Denial of the claim without adequate supporting evidence;
4. Failing to evaluate a claim objectively; and
5. Interpreting policy provisions in an unreasonable manner.

For insurers, developing a strategy for the investigation and analysis of Chinese drywall claims will be prudent, especially to ensure that claims practices are consistent and that policy provisions are interpreted and employed properly.

II. DEFENSES

In addition to the scope of applicable policy language and the exclusions found therein, insurers subject to Chinese drywall litigation may also be able to rely on certain legal or factual defenses to refute or mitigate claims against them. Typical causes of action alleged in drywall litigation include negligence, breach of contract, strict products liability, and fraudulent concealment. Under these causes of action, both property and bodily injury damages may be sought. Because of the various legal and factual scenarios that may be applicable to the installation of Chinese drywall in affected litigants' homes, the defenses available in each case will need to be evaluated on a case-by-case basis and may turn on such facts as the identity of the defendant, the cause of action asserted, and the damages at issue.

A. Legal Defenses

These defenses focus upon the legal requirements needed to bring and maintain a cause of action, as well as identification of the potentially liable party.

1. Causation

In claims by homeowners who assert that they have suffered physical injury as a result of Chinese drywall, defendants may attempt to establish that the drywall was not the proximate cause of those damages. To make these arguments, expert testimony will be required, and it is likely that both sides will make heavy use of experts to prove their case.

The Supreme Court's decisions in *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579, 113 S.Ct. 2786, 125 L.Ed.2d 469 (1993) and *Kumho Tire Company, Ltd. v. Carmichael*, 526 U.S. 137, 119 S.Ct. 1167, 143 L.Ed.2d 238 (1999) establish a "gatekeeper" function for trial judges for expert testimony under Fed. R. Evid. 702.⁵ The gatekeeper function "requires the judge to assess the reasoning and methodology underlying the expert's opinion and determine whether it is scientifically valid and applicable to a particular set of facts." *In re Williams Securities Litigation*, 496 F.Supp.2d 1195, 1230 (N.D. Okla. 2007). Considering this gatekeeper function, both parties will likely rigorously challenge the qualifications and methodologies asserted by each other's experts. It will be particularly important for insurers to oppose scientific conclusions unsupported or unexplored within the larger scientific community with respect to the damage-causing nature and purported categorical inferiority of Chinese drywall.

2. Failure to Mitigate Damages

Mitigation of damages will be a major issue with respect to the property damage allegations of these drywall claims. Mitigation of damages is an affirmative defense that the defendant bears the burden of proving. *See Utz v. Johnson*, 2004 WL 38228095 at *2 (E.D. Pa. 2004). To prevail on a mitigation theory, the defendant must demonstrate the reasonable measures plaintiff should have taken to reduce damages and that those measures would have reduced such damages. *Id.*

⁵ Under Rule 702 of the Federal Rules of Evidence, an expert with the necessary qualifications in the relevant field may give expert testimony if, (i) the testimony is based upon sufficient facts or data, (ii) the testimony is the product of reliable principles and methods, and (iii) the witness has applied the principles and methods reliably to the facts of the case. Fed. R. Evid. 702.

Because a damaged party has a duty to mitigate damages, questions will arise as to what the plaintiff did upon discovering that the drywall was “off-gassing” and causing damage to the electrical and HVAC systems of the home. Defendants in these actions will likely attempt to show that rather than taking action to stop the damages, i.e., removing the drywall, the plaintiffs allowed the drywall to remain in place and continue to cause damage to their homes after they had knowledge of the danger.

3. Shifting of Liability to Others

As with most litigated matters, upon service of the complaint a defendant will conduct an investigation into whether other parties may be responsible for the claims asserted against it. In strict product liability claims, this is a natural response as every party within the chain of distribution of a defective product can potentially be liable for any damages sustained by the ultimate end-user. RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY, § 1. Attempts to shift liability have already been made in the cases filed by homebuilders against the suppliers and manufacturers of the drywall. For example, in *Lennar Homes v. Knauf GIPS, et al.*, 11th Judicial Circuit, Florida, No. 09-07901CA23, and *Mitchell Company v. Knauf GIPS, et al.*, U.S.D.C. E.D. Louisiana, 09-2981, in an effort to shift liability away from themselves, the plaintiff homebuilders asserted claims of “common law indemnity” against the drywall manufacturers and suppliers. A common-law right of indemnity is a fault shifting mechanism operable generally when a defendant who has been held liable to a plaintiff solely by operation of law seeks to recover his loss from a defendant who is actually responsible for the accident that occasioned the loss. In addition, the *Lennar* plaintiffs asserted a claim of “vicarious liability” against Knauf GIPS, alleging that its Chinese subsidiaries’ acts of manufacturing the defective product were within Knauf GIPS’ control. Vicarious liability applies when one person is liable for the negligent actions of another person, even though the first person was not directly responsible for the injury.

Home builder plaintiffs may also suggest that they relied upon an architect’s specifications for the use of the drywall and seek to include the architect as a liable party. For example, in New York, architects owe a duty of care to the owner of a building who engaged them. *See In re September 11 Property Damage and Business Loss Litigation*, 468 F. Supp. 2d 508, 531 (S.D.N.Y. 2006). Such claims could then implicate Errors & Omissions policies issued to architects and other professionals involved in the design of the home.

Local suppliers of the drywall products may also attempt to blame the manufacturers and assert that they had no knowledge of the hazardous qualities of the drywall or that they had not been informed by the manufacturer of the potential risk of the drywall. Although this may not always be a complete defense, it can reduce the liability imposed upon a defendant. This is common in asbestos products litigation, where the supplier of an asbestos product either seeks indemnification from the manufacturer of the product, or, as is necessary at this advanced age of the litigation, the supplier seeks an off-set of damages at trial based on the measure of liability of a bankrupt asbestos product manufacturer.

It is also conceivable that the manufacturers of the drywall will attempt to place liability back in the hands of the builders, for using the drywall in the wrong environments. To date, many of the complaints that have been filed involve property located in the Southeastern United States, an

area that has high humidity and temperatures. The manufacturers could assert that the drywall was not designed for use in buildings in this type of environment. This defense, also referred to as the “component product supplier defense,” attempts to establish that the supplier of an inherently safe component part is not responsible for accidents that result when the part is integrated into a larger system that the component part supplier did not design or build. *See Travelers Property Casualty Co. of America v. Saint Gobain Technical*, 474 F. Supp. 2d 1075, 1086 (D. Minn. 2007) *citing Temporomandibular Joint (TMJ) Implant Recipients v. E.I. Du Pont De Nemours & Co.*, 97 F.3d 1050 (8th Cir. 1996).

B. Factual Defenses

Besides legal defenses, defendants in Chinese drywall litigation may be able to rely on certain factual circumstances that mitigate or refute liability, such as those situations where other products caused or substantially contributed to the damages alleged.

1. Design Defects

A design defect defense may be asserted by defendants in Chinese drywall litigation to show that the damages to affected plaintiffs’ homes were not caused by the drywall itself, but that it was installed in buildings that were not designed to be compatible with the drywall. For example, to defend the use of Chinese drywall, an installer may argue that there was improper or inefficient ventilation in building cavities, and had the ventilation been proper, the Chinese manufactured drywall would not have caused any problems. An argument could also be made that the home’s exterior vapor exhaustion design was insufficient to remove any gaseous emissions, thus increasing the effect created by the drywall’s “off-gassing.” Similarly, should investigation of the property’s damaged HVAC system determine that the electrical wiring in that system was not properly shielded or grounded, then an insurer could assert that any off-gassing from the drywall should not have been able to reach the copper itself, making the damage the result of an improper electrical installation, rather than the drywall itself.

2. Incorrect Specifications for Use

Akin to the “component product supplier defense” that manufacturers may assert to argue that Chinese drywall was not designed for use in buildings in particular environments, under an incorrect specification defense, an installer-defendant could argue that the supplier or manufacturer of the drywall failed to specify that the drywall should not be used in those climates or environments. Such an argument would further support an installer’s claim that it was unaware of the potential hazards of the drywall and thereby decrease its potential liability. If applicable, this defense will likely turn on the knowledge of the installer and the climate in which the drywall was installed.

3. Cross-Contamination and Synergistic Effect of Other Products

At the time of publication of this paper, no exhaustive investigation into the properties of Chinese drywall has yet occurred. As such, the possibility exists that the damages seen from “off-gassing” are actually a result of cross-contamination between multiple products. In other words, a defendant could attempt to establish that the drywall, by itself, is not causing the problem, but that the combination of the drywall and another product is the cause of the alleged

damages. Examples of materials that could present such negative interaction include defective anti-fungal and anti-bacterial treatments or fireproofing additives applied to the drywall.

In addition, other products used in the construction of the home, including caulking, exterior sheeting, and adhesives, could amplify the effect of the off-gassing. At this point, there is insufficient evidence to determine whether the alleged damages are caused solely by the drywall, some other source, or a combination of the two. Therefore, this defense ultimately depends on further investigation into the materials used in the manufacture of Chinese drywall and how they interact with common building materials used in the U.S.

A similar defense was presented in *Tompkin v. Philip Morris USA, Inc.*, 362 F.3d 882 (6th Cir. (Ohio) 2004), in which the defendant's expert testified that "smoking and asbestos exposure had an 'additive' effect – meaning that an individual's risk of disease is simply the sum of the risks from the respective exposures – but not a 'multiplicative' or 'synergistic' effect – meaning that the exposures act 'together to make it worse than it would be if it was exposed to either one or the sum of the two.'" *Tompkin* at 889 n. 3. Time may show that the drywall alone does not bring about the damages alleged by the plaintiffs, but requires the presence of another product as well.

4. Effect of Offshore Storage

Another potential defense on which insurers might rely relates to the fact that the drywall was shipped from China to the U.S. on seagoing vessels. Investigation of the conditions in which the drywall was stored during this journey could provide the basis for an argument that chemicals and other unknown substances may have permeated the drywall during transport, substantially changing its character after it left the control of the manufacturer. Not only would this expand the investigation for the reason the drywall may be causing these damages, it could also provide another class of defendants – overseas shipping companies – for their mishandling of the product.

C. Use of Experts

To prove the applicability of policy limitations, policy exclusions, and factual and legal defenses in court to protect against Chinese drywall claims, insurers will also want to consider the benefits of employing a variety of professionals to provide expert opinions in support of their defenses. Based on the complaints that have been filed in Chinese drywall litigation to date, the following is a brief review of some of the experts that may be expected to testify and provide reports in these matters.

1. Experts for Personal Injury Claims

a) Toxicologist

Toxicology is the study of poisons and their effect. In many of the drywall cases that have been filed to date, the plaintiff-homeowners allege personal injury. In order to prove, or disprove, that emissions from the drywall caused the injuries alleged, the testimony of a toxicologist will be necessary by parties on both sides of the litigation.

b) Epidemiologist

Epidemiologists study the incidence, distribution, and control of disease within a population. The testimony of an epidemiologist would be used to show how the incidence of injury allegedly caused by the drywall correlates with the installation of the drywall. This type of testimony is usually supported by statistical analysis and helps to establish proximate cause in negligence cases.

c) Neurologist

Some plaintiffs have alleged symptoms of dizziness as a result of inhalation of the emissions from the subject drywall. A neurologist's testimony could be used to prove or disprove that any neurological symptoms experienced by the plaintiff were caused by the drywall.

d) Pulmonologist

A pulmonologist is a physician who specializes in the study of the anatomy, physiology, and pathology of the lungs. Pulmonologists are used as experts in those cases wherein lung injury is alleged; such as asbestosis, silicosis, and tobacco litigation. Pulmonologists can review x-rays of the lungs and conduct biopsies of lung tissue to determine whether a specific substance caused an alleged disease. Because plaintiffs in several of the drywall cases thus far filed have alleged breathing problems, use of pulmonologists on both sides should be expected.

2. Experts for Property Damage Claims

a) Chemist

The testimony of a chemist would be used to explain to a jury how sulfides and other emissions are released from the drywall. It would also be helpful in describing the reaction between the sulfides and the copper that causes the blackening of the electrical components and the efforts that would be required to remediate the corrosion. Such testimony would likewise be useful in establishing proximate causation in negligence cases, as well as to substantiate the amount of any remediation conducted.

b) Architects, Estimators, and Engineers

These individuals could be used, particularly in the context of a class action, to provide an estimate as to the amount of drywall that was installed in the thousands of homes allegedly affected. In addition, their expertise could provide some insight into common industry practices involving drywall installation. They could also provide testimony as to whether it would be proper to use the drywall in certain situations, thereby establishing that the drywall was installed improperly, as opposed to it simply being a defective product.

c) Economists and Realtors

Economists could be used to establish any loss of income — or lack thereof — due to injury sustained by the plaintiffs. They could also be used, in conjunction with realtors, to establish any change of value of a home caused either by virtue of the fact that the home simply contains an

allegedly defective product (*i.e.*, the Chinese drywall), or as a result of a delay in the sale of the property due to buyers' perceptions of the health effects associated with the product.

III. CLASS CERTIFICATION

While numerous individual actions are expected to be filed by homeowners purportedly affected by the use of Chinese drywall in their homes, the present perception of Chinese manufactured drywall as a defective product has led to the filing of a significant number of class action lawsuits against manufacturers, distributors, and builders. As these class actions are (at the time of writing this paper) currently in the pre-certification stage, it remains to be seen whether they can satisfy the necessary requirements for a court to grant class certification. Because a substantial number of these lawsuits have been filed in federal court, and a substantial number of states have class certification requirements similar to the Federal Rules of Civil Procedure, the Federal Rules serve as a good roadmap to explain the standards that plaintiffs will need to satisfy in order to obtain class certification.

A. Certification under the Federal Rules

To obtain class certification under the Federal Rules, a party seeking certification must first satisfy four threshold issues under F.R.C.P. 23(a): 1) the putative class is so numerous that "joinder of all members is impracticable"; 2) "questions of law or fact common to the class" exist; 3) the claims of the representative party are "typical" of the class; and 4) the representative party can "fairly and adequately protect the interests of the class." If these threshold issues are met, the party seeking certification must then satisfy one of three additional requirements under F.R.C.P. 23(b) by showing that 1) prosecuting separate actions would create a risk of either inconsistent adjudications or adjudications with respect to individual class members that would be dispositive of the interests of the other members or would substantially impair their ability to protect their interests; 2) the party opposing the class has acted or refused to act on grounds that apply generally to the class, so that final injunctive relief or corresponding declaratory relief is appropriate respecting the class as a whole; or 3) questions of law or fact common to class members predominate over any questions affecting only individual members, and that a class action is superior to other available methods for fairly and efficiently adjudicating the controversy.

1. F.R.C.P. 23(b)(3) Requirements

For plaintiffs in these lawsuits, satisfying the necessary criteria to achieve class certification may prove difficult in a number of ways. Certification difficulties typically arise at the second prong of Rule 23's requirements. For instance, when attempting to obtain certification under Rule 23(b)(3), parties must show that the questions of law or fact common to class members predominate over any questions affecting only individual members, and that a class action is superior to other available methods for fairly and efficiently adjudicating the controversy. Considering this "predominance" requirement, parties seeking certification may have difficulty showing damages on a classwide basis. As the science is still developing on this issue, and the initial Florida Department of Health report was inconclusive because of cross-contamination between the samples, whether particular plaintiffs were damaged by the Chinese drywall or from some other event is uncertain. Clearly, as conditions can vary factually among class members,

parties opposing certification may have various individualized factual defenses to refute predominating issues concerning liability and damages. These defenses, similar to those discussed in the “Defenses” section above, would seek to demonstrate a cause of loss other than the drywall. They would include: 1) improper or inefficient ventilation in building cavities; 2) improper exterior vapor exhaustion barrier or design; 3) faulty placement of HVAC equipment; 4) specification of the wrong drywall type for warm, humid climates; 5) cross-contamination with other products; and 6) defective anti-fungal treatments, anti-bacterial treatments, or fireproofing additives applied to the drywall. Based on these varied circumstances — as well as the fact that some class members may never sustain injury or have sustained injury because of other individualized factors affecting the drywall, there may be no evidence of damages that can be proven on a common classwide basis.

Rule 23(b)(3) also states that pertinent findings to consider in determining whether to certify a class under the Rule include: (1) the class members’ interests in individually controlling the prosecution or defense of separate actions; (2) the extent and nature of any litigation concerning the controversy already begun by or against class members; (3) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; and (4) the likely difficulties in managing a class action. With respect to item four, even if a party could establish a predominating common theme — such as showing that *all* Chinese drywall is defective — individual liability and damage issues will likely turn the litigation into an unmanageable series of mini-trials that are more appropriately litigated as individual cases. In this respect, class members may have a greater interest in controlling their individual actions so as not to jeopardize the strength of their case against others where liability and damages are not so clear.

2. F.R.C.P. 23(b)(2) Requirements

In addition to arguing the sufficiency of certification by satisfying the requirements of Rule 23(b)(3) on a “damages-type” basis, plaintiffs may also seek class certification on an “injunctive relief” basis pursuant to Federal Rule 23(b)(2). This rule specifically requires that the moving party show that the party opposing class certification has acted or refused to act on grounds that apply generally to the class, so that final injunctive relief or corresponding declaratory relief is appropriate with respect to the class as a whole. These plaintiffs may have brought claims for medical or air quality monitoring in an effort to bypass the damages concerns addressed in Rule 23(b)(3). Medical monitoring is a theory seeking the recovery of damages for persons who do not yet have an injury, but merely have an increased risk of sustaining one. A request for medical monitoring seeks to recover the costs of long-term testing necessary to detect latent injury that may develop as a result of an alleged exposure to toxic substances. In effect, plaintiffs would attempt to show that persons living in homes with Chinese drywall may be exposed to allegedly harmful toxins, and while these toxins may not cause immediate injury, they could potentially manifest at some later point in time. While this certification strategy has been employed under different factual scenarios — most notably asbestos exposure — the fact that it is not universally accepted in all jurisdictions and the high standard of proof needed when its use is, in fact, permitted by the courts, makes this a difficult approach towards obtaining class certification.

In the case of *In re Marine Asbestos Cases*, 265 F.3d 861 (9th Cir. 2001), the Ninth Circuit Court of Appeals reiterated a common set of elements that courts have adopted, with minor variations, for a plaintiff to prove in order to recover medical monitoring costs. These include the following:

1. Plaintiff was significantly exposed to a proven hazardous substance through the negligent actions of the defendant(s).
2. As a proximate result of exposure, plaintiff suffers a significantly increased risk of contracting a serious latent disease.
3. That increased risk makes periodic diagnostic medical examinations reasonably necessary.
4. Monitoring and testing procedures exist that make the early detection and treatment of the disease possible and beneficial.

The Court also explained, as adopted from the Third Circuit Court of Appeals in *In re Paoli R.R. Yard PCB Litigation*, 916 F.2d 829 (3d Cir. 1990), that “the appropriate inquiry is not whether it is reasonably probable that plaintiffs will suffer harm in the future, but rather whether medical monitoring is, to a reasonable degree of medical certainty, necessary in order to diagnose properly the warning signs of disease.” *Paoli*, 916 F.2d at 851. As the science with respect to the alleged harms caused by Chinese drywall is still developing, the above criteria, which consistently employ high standards such as “significantly exposed to a proven hazardous substance,” and “significantly increased risk of contracting a serious latent disease,” may be difficult to satisfy when it is unclear whether medical monitoring is necessary for early diagnosis and treatment of the potential alleged injury.

B. Class Action Jurisdiction and Removal

In the event that a party is faced with a class action lawsuit in state court seeking damages caused by defective drywall, that party will also want to evaluate whether the action is removable to federal court under the Class Action Fairness Act (“CAFA”). Although not an absolute rule, parties involved in class action litigation tend to view federal court as a more favorable forum in which to resolve class certification issues.

In determining whether a case is removable under CAFA, parties should initially look to whether the aggregate value of the case is \$5 million or more and the class includes 101 or more class members. Parties will also need to evaluate the citizenship of class members, as this plays a pivotal role in determining whether a federal court has jurisdiction over a class action. If less than one-third of the plaintiffs and the primary defendants are from the same state, then the action will automatically be removed to federal court. If more than two-thirds of the plaintiffs and the primary defendants are from the same state, then the action automatically remains in state court. If more than two-thirds of the plaintiffs are from the same state, and at least one in-state defendant is present, then the action can also remain in state court if certain criteria are met. If between one-third and two-thirds of the plaintiffs and the primary defendants are from the same state, then the action will be removed to federal court at the discretion of the federal judge, taking into account certain factors enumerated in the Act. These considerations are codified at 28 U.S.C.A. § 1332 (2009).

As CAFA includes other considerations and exclusions with respect to removal under its provisions, parties are cautioned to look carefully at its provisions to ensure that all of its terms are satisfied.

C. Insurance Company Class Actions

Plaintiffs may argue that the inclusion and/or specification of Chinese drywall on property repair estimates violate the insurers' duty to repair or replace damaged property with "like kind and quality" materials; language that is often found in homeowners' insurance contracts. However, it appears unlikely that class certification could be obtained against an insurer that made no systematic corporate practice of specifying this type of drywall.

A loose, yet apt analogy to such a class action against an insurer can be found in the aftermarket (non-OEM) crash parts cases brought against insurance carriers for specifying allegedly inferior and unsafe Taiwanese crash parts in automobile repair estimates. In at least one national class action — which made its way to the Illinois Supreme Court only to be decertified as inappropriate for class action treatment — plaintiffs argued that because of their reduced cost and inferior value, the mere *specification* of such parts resulted in damages to policyholders. In the same case, plaintiffs also argued that all class members who actually had the parts installed on their vehicles (as compared to those who simply had them included in their estimates), were entitled to damages. Plaintiffs fashioned the above two theories as "specification" and "installation" damages. The Illinois Supreme Court, however, rejected both damage theories, indicating that the former was fundamentally inconsistent with contract law and that the latter was far too speculative and did not establish that damages could be calculated to a reasonable degree of certainty. *See Avery v. State Farm Mut. Auto. Ins. Co.*, 835 N.E.2d 801 (Ill. 2005).

Nevertheless, plaintiffs in a Missouri aftermarket crash parts action recently fared much better on this issue. In that case, the plaintiff obtained a favorable jury verdict for the class, finding the defendant insurer liable for specifying aftermarket parts as well as omitting certain repair procedures. While the trial court initially overturned the \$17.4 million jury award, holding that plaintiffs, during their case-in-chief, failed to prove by a preponderance of the evidence that they had suffered damages from the insurer's policy permitting the specification of aftermarket crash parts for repairs or that certain omitted repairs were not done, the Missouri Court of Appeals reversed and reinstated the jury verdict. The Court of Appeals found that plaintiffs successfully demonstrated to the jury that aftermarket crash parts are categorically inferior to original equipment manufacturer ("OEM") parts and that certain repair procedures were not performed. The Court also held that the defendant's mere payment to policyholders for the reduced cost of aftermarket parts was sufficient to establish damages as the payment was insufficient to return their vehicles to pre-loss condition. *See Smith v. American Family Mutual Insurance Company*, - -- S.W.3d ---, 2009 WL 1181490 (Mo. Ct. App. May 5, 2009).

While plaintiffs may be successful in obtaining class certification against the manufacturers and suppliers of Chinese drywall, due to varying policy language and claims practices, it will undoubtedly be more problematic for them to obtain class certification against those insurers who specified its use.

D. Alternative Approaches to Mass Litigation

In the event that class certification is deemed not feasible or is denied by the courts, plaintiffs may look to joinder and declaratory or injunctive relief as possible alternatives to proceed with similar lawsuits on a mass basis. Such an approach would be used by plaintiffs to simplify court

proceedings with respect to liability and damages by having specific causes of action determined on an aggregate basis. Under Federal Rule of Civil Procedure 20 governing permissive joinder, plaintiffs may be joined in one action if: 1) they assert any right to relief jointly, severally, or in the alternative, with respect to or arising out of the same transaction, occurrence, or series of transactions or occurrences; and 2) any question of law or fact common to all plaintiffs will arise in the action. As plaintiffs will be seeking recovery based on their insurance policy, a court could find joinder appropriate if a common wrong, such as a failure to provide coverage for losses under specific policy provisions, was at the center of the action.

Furthermore, unfavorable declaratory rulings or rulings granting injunctive relief could seriously impact an insurer's defense of Chinese drywall-related actions by declaring policy language ambiguous and forestalling existing business practices. Section 28 U.S.C. 2201 of the United States Code and various other state enabling statutes permit the use of declaratory judgments to "declare the rights and other legal relations of any interested party seeking such declaration, whether or not further relief is or could be sought. Any such declaration shall have the force and effect of a final judgment or decree and shall be reviewable as such." *See* 28 U.S.C. § 2201 (2009). While declaratory judgments are commonly used by the insurance industry to resolve coverage-related litigation expeditiously, an unfavorable ruling could lead to considerable exposure on this issue, considering the amount of allegedly defective drywall used in homes damaged by the 2004-2008 hurricane seasons and the unresolved issue regarding whether loss or damage caused by the drywall is covered under the policy provisions at issue.

IV. REINSURANCE

Although issues pertaining to Chinese drywall are expected to have a greater impact on first and third-party insurance coverage, a number of reinsurance issues could also be implicated by the emergence of these types of claims. In particular, claims against individual builders, suppliers, importers, and others could lead to a significant volume of potential loss and, consequently, to large settlements or verdicts that may, in turn, lead to significant billings to reinsurers. Moreover, protracted litigation of both the liability and coverage issues may result in litigation expenses and other costs being billed to reinsurers in most instances. Once the first- and third-party claims are resolved and the declaratory judgment actions are concluded (as well as any litigation among insurers for contribution), the insurers will look to their reinsurers to absorb their part of the risk.

A. Allocation of Loss

The underlying Chinese drywall claims appear to be similar to asbestos or other "exposure" or "progressive injury" type claims for purposes of bodily injury in that the claimants are likely to argue that the exposure occurred over time from the date of installation through the date of remediation (or discovery). As such, multiple policy years may be implicated by these bodily injury claims. This may be less likely in the property damage context insofar as the damage arguably occurred (a) when the drywall was installed or (b) when the drywall "became" defective. Of course, damage to other parts of the home, such as corrosion of pipes, may be progressive in nature and thereby implicate multiple policy periods as well.

Determining how loss should be allocated requires an understanding of the approach used in the applicable jurisdiction. For example, this includes determining which policy years were

implicated by the loss and then determining if the relevant jurisdiction requires allocation “horizontally,” whereby policies for all involved policy years participate on a pro rata basis (*i.e.*, the “filling bathtub” approach) or “vertically” (the “all sums” approach) under which the policyholder may select the policy year to which the loss will be applied and the insurers are left to determine the appropriate contribution among surrounding policy years.

In the reinsurance context, allocation of the underlying loss may impact the ceding insurer’s ability to bill reinsurers for the loss as a single occurrence within one policy year. Also, the year(s) to which a loss is allocated will determine whether the ceding insurer may bill the loss to a reinsurance agreement that has a more favorable (lower) retention. This will depend, in part, upon the nature of the reinsurance agreements implicated by the loss. Facultative reinsurance generally follows the form of the underlying insurance and will subject the reinsurer to the same allocation principles as the ceding insurer. Treaty reinsurance covers a book of business so the pertinent allocation question requires examination of the policies or years when the loss was allocated as well as the policies or years when the loss adjustment expenses, if any, were allocated.

B. Number of Occurrences

In any underlying third-party claims against manufacturers, importers, distributors, and installers of the drywall products, there is the potential for disagreement between the policyholders and the insurers regarding the number of occurrences, particularly when the claims being submitted pertain to multiple homes or other structures utilizing the Chinese drywall. Also, it remains to be seen whether workplace exposure claims will arise from the manufacturers, distributors, and installers as well. On the manufacturing and distribution side, where the liability policies are likely to include significant deductibles or self-insured retentions and high policy limits, the underlying policyholders may argue that multiple claims constitute a single occurrence with total damages surpassing a single deductible or self-insured retention, whereas the insurers might seek to characterize individual injuries to property or bodily injury as separate occurrences that never surpass the deductible or retention.

Conversely, in the situation of the contractor or home builder, whose liability policies typically include a minimal deductible (\$500 or \$1,000) and limits of \$500,000 to \$1,000,000 per occurrence and \$2,000,000 aggregate, the underlying policyholders are likely to argue that each loss is a separate occurrence in order to maximize the available limits, depending upon the number of claims being presented. This will hold true particularly where the policyholder is a builder or developer involved in the construction of multiple homes or other structures.

This distinction in evaluating the number of occurrences has the potential to impact billing presentations to reinsurers. In particular, in the context of “excess of loss” treaty reinsurance, where the ceding insurer retains a specified amount of the loss before any amount may be billed to reinsurers. “Loss Occurrence” is traditionally a defined term in treaty reinsurance that may not be the same as (and is often broader than) the definition of “occurrence” in the underlying policy. Therefore, ceding insurers and their reinsurers will need to be sensitive to such issues as the distinction between bodily injury and property damage claims (which may constitute separate “occurrences” and separate “Loss Occurrences”), injuries arising out of operations at a single “site,” injuries arising from the “same causative agency,” and the extent to which the reinsurance

agreement permits aggregation of injuries or damages as one Loss Occurrence. Aggregation of claims, injuries arising out of work at one “site” and injuries arising from the “same causative agency” are all issues that are likely to arise from both the property damage and bodily injury alleged in connection with the Chinese drywall claims.

C. Number of Retentions

Directly related to the number of occurrences comprising a loss or series of losses is the determination of the number of retentions that are to be taken by the ceding insurer in its billing to reinsurers. In a typical “excess of loss” reinsurance agreement, the ceding insurer will retain \$1 million of the loss for its own account, and amounts in excess of that retained amount are billable to the reinsurer, up to the applicable reinsurance limits. If the ceding insurer settles three separate “occurrences” for \$500,000 and cannot justify aggregation of those claims or cannot otherwise present them as a single Loss Occurrence to the reinsurer, the retention will not be breached and there can be no reinsurance billing. However, if there is some reasonable basis for presenting the losses as a single Loss Occurrence, the ceding insurer would retain \$1 million and present the reinsurer with a billing for the remaining \$500,000.

Hypothetically, in a given loss involving property damage or bodily injury arising in connection with a number of homes that were built using the Chinese drywall, the ceding insurer might have taken the position in the underlying claim that each home constituted a single “occurrence” under the policy, but based upon the definition of Loss Occurrence in the reinsurance agreement, those same individual “occurrences” may be subject to aggregation or may otherwise be presented to the reinsurer(s) as a single Loss Occurrence, thus allowing the ceding insurer to exceed the stated retention and bill its reinsurers for the excess amount. Much of the foregoing is rather fact-specific and dependent upon the definitions contained in the reinsurance agreement(s).

Whether the retention is exceeded for reinsurance billing purposes may also depend upon what amounts may be included in a billing to reinsurers, commonly referred to as the ceding insurer’s “Ultimate Net Loss.” Ultimate Net Loss often will include not only amounts paid as judgments or in settlement of claims, but also amounts paid for the extra contractual liability (“ECO”) of the ceding insurer (such as “bad faith” damages), excess of policy limits (“XPL”) claims, as well as amounts incurred in investigating claims and defending the underlying policyholder in litigation, typically defined as Allocated Loss Adjustment Expenses (“ALAE”) or Loss Adjustment Expenses (“LAE”). In addition, some reinsurance agreements allow the ceding insurer to include declaratory judgment expenses as part of the Ultimate Net Loss. Such amounts impact the potential billing to reinsurers in that they may (and often can) be included in the amounts applied to the ceding insurer’s retention.

D. Other Reinsurance Issues

Other issues that can have reinsurance implications may also arise from litigation and settlement of bodily injury and property damage claims stemming from the use of Chinese drywall. These are discussed briefly here.

1. Ex Gratia Payments

An ex gratia payment is one that is made by the ceding insurer to its policyholder, or to third-parties on behalf of the policyholder, in connection with a claim or claims that plainly do not fall within the scope of the coverage afforded by the policies issued by the insurer to the policyholder. Such payments are often made for “business” purposes, such as where the policyholder is a significant source of premium revenue for the insurer and the settlement of a particular claim, while technically outside the scope of the coverage provided, will avoid the costs of litigating the coverage issue and at the same time will operate to preserve the ongoing business relationship between the insurer and policyholder.

Some reinsurance agreements may be interpreted to allow for the recovery of such ex gratia payments by the ceding insurer from its reinsurers. Other agreements may specifically exclude such payments from the amounts recoverable under the reinsurance agreement. In the context of Chinese drywall claims, a telltale sign of an ex gratia payment might be where the loss was plainly excluded or otherwise not covered under the policy but was paid nonetheless. While reinsurers might not question the business judgment of the ceding insurer in settling a questionable claim in order to avoid protracted and expensive litigation, a settlement that appears to have been made solely to preserve a ceding insurer’s business relationship with its policyholder may be subject to challenge as ex gratia.

As sometimes occurs when “new” types of losses begin to arise that appear to have far-reaching potential for lengthy litigation of both liability and coverage issues, some insurers may be inclined to settle claims early to avoid excessive costs and other exposure, and then attempt to recoup some of the amounts paid from their reinsurers. This “rush to settlement” may result in ex gratia payments. Whether such payments may be recovered under the applicable reinsurance agreements depends upon the wording of the agreements, the specific facts giving rise to the settlement, and how the payments are characterized by the ceding insurer. While a reinsurer might be inclined to deny a billing that it perceives as constituting an ex gratia payment, there may be an argument that such settlement benefited both the ceding insurer and reinsurer by cutting off: 1) a claim that had the potential for excessive litigation expenses; 2) a claim that had considerable exposure from an indemnity perspective since it is a relatively uncharted area scientifically; and 3) from an ECO and XPL perspective, if the claim went unexpectedly or a surprise verdict were rendered.

2. Declaratory Judgment Expenses

As discussed above, litigation on a large scale, such as class actions or multiple lawsuits filed in one or more jurisdictions by several homeowners, could result in the insurers incurring ALAE or LAE that equals or exceeds any settlements or judgments. Treaty reinsurance often includes expenses incurred in the claims investigation and litigation process. In some instances, Declaratory Judgment expenses are specifically defined as amounts that may be included in a billing under the reinsurance treaty, other times not, but depending upon the definition of Ultimate Net Loss and its inclusion of (and definition of) LAE or ALAE, there is at least an argument to be made that such expenses are covered. Again, such expenses, when included in the definition of Ultimate Net Loss, may result in a reinsurance billing where the indemnity paid

alone would not. Alternatively, such payments have the potential to significantly increase a reinsurance billing.

By contrast, in the facultative reinsurance context, the facultative certificate often “follows the form” of the reinsured policy, meaning that the terms, conditions, and definitions set forth in the reinsurance agreement are the same as the terms and conditions of the underlying policy. For this reason, Declaratory Judgment expenses are generally viewed as not included in ALAE unless the facultative certificate specifically includes them as covered expenses. This is based upon the fact that the underlying policy typically covers expenses incurred for the benefit of the policyholder, and courts have held that Declaratory Judgment expenses cannot be characterized as having been incurred for the benefit of the underlying policyholder, but rather for the benefit of the ceding insurer.

3. Choice of Law

The claims from Chinese drywall have the potential to involve parties not only from the United States, but from around the world. Questions will arise regarding which states’ laws govern determinations of liability and coverage issues, including allocation of loss, number of occurrences, and other matters. In the realm of facultative reinsurance, where the reinsurer’s obligations to the ceding insurer follow the form of the insurer’s obligations to its policyholder, those underlying determinations of the applicable law are important and potentially binding upon the reinsurer. While treaty reinsurance often includes a dispute resolution provision that includes a choice of law clause (or, alternatively, an explicit statement that the arbitration panel is not bound to follow the strict rule of law of any jurisdiction), the broad range of jurisdictions that may be implicated by Chinese drywall claims has the clear potential for confusion or “forum shopping” at the reinsurance level in determining whether claims may be aggregated and what constitutes a single Loss Occurrence for the purpose of determining how many retentions must be taken by the ceding insurer.

4. Extra-Contractual Obligations and Excess of Policy Limits Claims

Because Chinese drywall claims are relatively new and fall into a class of their own, there remain many underlying coverage questions to be resolved. While insurers, policyholders, and courts attempt to figure out the extent to which such claims are covered and whether existing policy definitions and exclusions are applicable, there is the potential for policyholders to assert extra contractual claims against insurers. Similarly, there is the potential for ceding insurers and their underlying policyholders to be faced with judgments in excess of the underlying policy limits. Such claims may result in increased billing and greater exposure to reinsurers.

Finally, early reporting of Chinese drywall claims by ceding insurers to their reinsurers may benefit both the ceding insurers and reinsurers. Such early reporting will allow the reinsurers to set appropriate limits, and in the end, may facilitate the reinsurance billing process if the reinsurers are apprised of the nature of the claim(s).

V. RECOVERY OPPORTUNITIES AND RISKS

A. Opportunities

Although Chinese drywall will generate a great deal of troublesome coverage and related insurance and litigation issues, it also offers subrogation and other recovery opportunities. These recovery opportunities exist in the typical property insurance subrogation context whenever a carrier reimburses its insured for removal or replacement of drywall or damaged HVAC equipment. Subrogation targets will include builders, subcontractors, building inspectors, drywall sellers, drywall distributors, as well as the drywall manufacturers themselves. It is also important that carriers educate their workers' compensation units about such recovery opportunities so that proper steps can be taken to protect and assert subrogation liens whenever an insured's employee alleges detrimental effects arising from exposure to Chinese drywall in the workplace environment.

Carriers who face liability claims against their insureds that were associated with the installation of the Chinese drywall (builders, subcontractors, building inspectors, architects, etc.) should take appropriate steps from the outset to recognize and assert contribution or indemnity claims back "upstream" against the drywall sellers, distributors, and manufacturers themselves. Although each of these circumstances gives rise to seemingly strong recovery opportunities, unless they are recognized and protected from the outset – as is further addressed below – the recoveries can be easily jeopardized or limited. These reimbursement efforts are also complicated by a plethora of legal hurdles; most of which will usually be manageable, but only if proper steps are taken in the beginning and along the way.

B. Hurdles/Risks

1. Statutes of Repose

a) Improvements to Real Property

Many jurisdictions have statutory time limitations on when a claim may be asserted alleging improper or negligent improvements to real property; these would invariably apply to the installation of Chinese drywall. While some of these statutes require that the alleged "loss" must arise within a certain defined time period after the improvement is completed, other such statutes of repose require that any lawsuit must be filed (irrespective of when the cause of action accrued) within a certain defined period after the improvement is completed.

Florida, by way of example, has a strict statute of repose addressing improvements to real property, §95.11, that requires that suit must be filed within four years from an owner taking possession of the property, unless the problem involves a latent defect – which is subject to a maximum period of 10 years after possession is taken or a contract is completed.

Louisiana has another strict statute of repose, §9.2772, requiring that suit be filed within five years of the date of registry of acceptance of work by the owner in the local mortgage office or five years from occupancy of the improved structure.

These statutes of repose vary greatly from state to state, and must be analyzed and addressed immediately after any claim is presented so that recovery opportunities are not squandered while the claims are being reviewed and adjusted. Carriers may need to file “savings actions” (claims against subrogation targets made with their insureds’ cooperation before the coverage issues have been decided and the claim has been adjusted) immediately after such a claim is presented, so as to preserve the subrogation claim due to these statute of repose limitations.

It should be noted that these statutes of repose as to improvements to real property usually do not apply to protect manufacturers, distributors, or sellers of defective building products (although some do), but instead are intended for the protection of builders, contractors, architects, and engineers involved with the construction of the improvements. The protected (or unprotected) entities under the appropriate state statute should be analyzed from the outset.

b) Product Liability

Some jurisdictions have also enacted statutory time limitations on how long after a defective product has been sold (or received) that a product liability lawsuit may be filed, and these would apply to protect the sellers, distributors, and manufacturers of Chinese drywall. These statutes may even apply in certain states to protect builders who incorporated the Chinese drywall into the home or other structure if the buyer paid the builder for the home and it included the drywall (arguably thus making the builder a seller of the product).

While some of these statutes, like those above addressing improvements to real property, require that the alleged product liability “loss” arise within a certain defined time period after sale, other such statutes require that any suit must be filed (irrespective of when the cause of action accrued) within a certain defined period after the sale of the product.

Florida has such a statute of repose, §95.031, that requires that any product liability suit must be filed within 12 years from delivery of the product to the first purchaser (unless the product has an expected life span in excess of 10 years – as drywall would – in which case suit must be filed within the expected life span of the product). Georgia and Alabama have similar 10 to 12 year product liability statutes of repose, while Louisiana and Mississippi, in contrast, have no such limitations.

As these statutes of repose also vary greatly from state to state, they must be analyzed and addressed immediately after any claim is presented so that recovery opportunities are preserved. As noted above, insurance carriers may need to file “savings actions” with the assistance of their insureds immediately after claims are presented so as to preserve future subrogation claims in light of these statutes of repose.

2. Economic Loss Doctrine/Implied Warranty Claims

To the extent that any later recovery claim will lie against a seller, distributor, or manufacturer for merely the replacement of the drywall itself, parties will need to recognize the limitations imposed by the jurisdiction’s application of its “economic loss doctrine” and the probable need to assert timely breach of implied warranty claims.

While the economic loss doctrine varies somewhat from jurisdiction to jurisdiction, the nearly universal effect is that if a product is defective, but only causes damage to itself (and not “other property” or personal injuries), then negligence and product liability claims are not available, and contract law alone applies. This, in turn, usually requires that any claim be asserted based upon an alleged breach of an explicit or an implied warranty. In the absence of beneficial explicit warranties, reliance on implied warranty statutes (creating and enforcing implied warranties of merchantability and implied warranties of fitness for a general purpose) usually require filing of suit on such claims within four years after the product is sold.⁶

As this issue and the applicable statutes of limitations vary greatly from state to state, it must be analyzed and addressed immediately after any claim is presented so that recovery opportunities are preserved. Similar to the manner by which statutes of repose must be addressed, insurance carriers may need to file “savings actions” immediately after claims are presented so as to preserve future subrogation claims in light of the economic loss doctrine and the stricter statutes of limitations on implied warranties.

C. Evidence Retention / Preservation and Proper Expert Use

1. Evidence Retention / Preservation

If any carrier or other party intends to properly preserve or assert a recovery action in the face of a first- or third-party claim, it must appreciate from the outset that, irrespective of any initial coverage or liability position as to the claim itself, it would be well-served to take steps to properly identify and preserve all pertinent evidence underlying a future liability claim against the builder, contractor, building inspector, seller, distributor, or manufacturer of the Chinese drywall materials.

Two important steps in this regard will be to: (1) place any and all possible recovery targets on notice of the possible future claim, giving them an opportunity to visit the property and investigate the claims before the suspect drywall is removed or discarded; and (2) take and preserve a sample of the suspect drywall, possibly in coordination with the recovery targets, and with the cooperation of the property-owners.

These steps may be problematic if the carrier or initial defendant is aggressively denying liability, coverage, or other responsibility, because such party will not want such actions to cause any property-owner to rely on such actions to indicate that liability, coverage or legal responsibility was being accepted. Properly presented “reservations of rights” (or similar

⁶ As an example, the state of Texas adopted the “economic loss doctrine,” in the case of *Mid Continent Aircraft Corp. v. Curry County Spraying Service, Inc.*, 572 S.W.2d 308, 312-13 (Tex. 1978). In addition, any claim for breach of implied warranties must be filed within four years of the date of sale or delivery, irrespective of the latent nature of any defect. Tex.Bus. & Com.Code § 2.725; *Buffington v. Lewis*, 834 S.W.2d 601 (Tex.App.-Hou. 1 Dist. 1992). On the other hand, although the Florida Supreme Court has adopted the economic loss doctrine in the case of *Florida Power & Light Co. v. Westinghouse Elec. Corp.*, 510 So.2d 899 (Fla. 1987), the Florida statute of limitations for UCC implied warranty violations, § 95.11(3)(k), dictates that lawsuits arising from such claims need only be asserted within four years from when the defect is actually discovered. See, e.g., *R.A. Jones & Sons, Inc. v. Holman*, 470 So.2d 60 (Fla. App. 3 Dist. 1985).

statements or agreements noting that such communications with possible third-party recovery targets is not any indication or coverage or liability) should act, however, to prevent any such unjustified reliance, while at the same time avoiding future spoliation defenses by recovery targets.

2. Workers Compensation Causation Issues

Workers' Compensation administrative judges often require lower standards of causation between workplace environments and alleged workplace "injuries." In turn, workers' compensation carriers faced with such claims must appreciate that in order to successfully assert a subrogation claim, they may need to retain the claimant's expert or a new one (if the expert had denied a nexus previously between the workplace and the claimed ailment) to properly support a claim against a subrogation target.

It is important that any party involved consider these important evidence preservation and expert practices at the earliest stages of involvement to be able to best avail themselves of all possible recovery options later on.

D. Perfecting the Contribution/Indemnity Claim: Releases and Settlements

Builders or other contractors seeking to maintain business reputations by reimbursing property-owners for removal or repair of Chinese drywall or damaged HVAC equipment must take certain steps to perfect any contribution or indemnity claim against the seller, distributor, or manufacturer of the drywall. This usually requires obtaining a complete general release from the property owner as to their claims arising from the drywall, thus extinguishing the property owner's own claims against such entity.

Under normal circumstances, this is usually not problematic, but it may be an insurmountable burden if the property owners refuse to cooperate out of concerns that the drywall exposure may have longer term effects and that they are not comfortable providing such a release to the reputable builder or contractor remedying the initial property damage claim. This issue may need to be resolved with the use of well-crafted releases, with a limited, yet adequate scope that not only extinguishes the dwelling owner's compensated property damage claim, but preserves the separate and distinct possible future personal injury claim.

Additionally, such reputable builders or contractors will want to ensure that their payments are not viewed as "voluntary" payments, which may not give rise to contribution actions in certain jurisdictions. This may require that such parties obtain expert opinions before resolution with the property owners as to the defective nature of the drywall at the specific property, whether from the owners' expert, or an expert retained by the builder or contractor.

Before settling such third-party claims, these issues must be addressed so as to properly protect all available recovery efforts.

E. Building Inspector Statutes

Although many parties may consider seeking recovery against home or other building inspectors for alleged failures to recognize and address the Chinese drywall issue, many states have enacted

statutes that offer liability limitations against building inspectors licensed in that jurisdiction. The most powerful protection in such statutes comes in the form of a shortened statute of limitations for claims of negligent inspection. By way of example, Mississippi's law requires that any action to recover damages "for any act or omission of a home inspector relating to a home inspection that he conducts shall be commenced within three years after the date a home inspection is completed or the action shall be barred." § 73-60-15. Similarly, in California, "the time for commencement of a legal action for breach of duty arising from a home inspection report shall not exceed four years from the date of the inspection." Cal. Bus. & Prof. Code § 7199. As building inspector statutes vary from state to state, this issue must be analyzed and addressed immediately after any claim is presented so that recovery opportunities are best preserved.

F. Recoverability of Claims against Sellers, Distributors, and Manufacturers

As discussed earlier, present litigation involving Chinese drywall focuses on particular drywall that was manufactured overseas by Knauf Plasterboard Tianjin Co. in Tianjin, China (Knauf Gips KG, is its parent company in Germany) and Taishan Gypsum Co. in Shandong, China; and that was exported to the United States by the China-based company, Rothchilt International. Because both China and Germany are parties to the "Hague Convention on Service Abroad of Judicial and Extra-Judicial Documents in Civil and Commercial Matters," these entities may be litigated against directly. Service of process can be effectuated in China and Germany under the Convention respectively through the Chinese Central Authority and one of the 16 designated German Central Authorities. While this procedure certainly facilitates lawsuits against these foreign corporations, due to pleading translation requirements and additional necessary procedural steps, anyone asserting such claims must go into the litigation knowing that it will be time-consuming and more expensive.

Furthermore, "recoverability" is often a greater issue than "liability" when dealing with claims against foreign entities such as these. Knauf Gips KG, the parent company in Germany, is a well-funded multi-national company that is seemingly well-insured. However, liability against the parent company for the defective products of its subsidiary is far from certain, and will remain suspect until such time as future discovery efforts may disclose a greater awareness by the parent company of the issues giving rise to the defective nature of the product.

Locally in the U.S., much of the focus has been on Banner Supply Co. in Miami, Florida; and L&W Supply (a subsidiary of USG Corp.) based in Chicago, Illinois (with distribution centers around the country). Under most states' product liability laws, distributors and sellers in the chain of commerce are responsible for dangerous and defective products that they sell or distribute, irrespective of a lack of negligence or other fault. Therefore, insurance coverage limitations aside, it will be easier and quicker to simply assert claims against these entities if the U.S. supplier can be identified. If insurance coverage problems begin to arise for these entities, recovery efforts will need to again focus on the foreign entities.

Recent tort reform efforts have resulted in more limited product liability laws in certain states. Some new laws prohibit product liability claims against pass-through sellers or distributors, such as those involved here. By way of example, Mississippi's Civil Justice Reform legislation of 2004 changed the law to allow the "innocent-seller" defense; that is, where a retailer sells a product that it does not change in any way, and the retailer is unaware of any obvious defect in it,

the retailer is essentially immune from liability. *See* Miss. Code Ann. § 11-1-63(h) (“It is the intent of this section to immunize innocent sellers who are not actively negligent, but mere conduits of a product”). Such a statute would probably act to bar product liability claims against distributors and sellers of the Chinese drywall, unless awareness of the defective nature of the product can be demonstrated.

Subrogation and other reimbursement efforts will invariably be impacted by a variety of these product liability recoverability issues. Therefore, these legal and insurance factors should be reviewed and addressed before any new claim is presented so that maximum recovery opportunities can be realized.

G. Florida’s Chapter 558

Under Florida law, F.S.A. § 558.001, et seq., claimants alleging the use of defective construction materials would be required to undertake certain preliminary administrative or mandatory claim negotiation procedures in accordance with the state’s Chapter 558 pre-suit construction defect statutory process before allowing any plaintiff to file suit against the builder, the installation subcontractor, or even the supplier. Claims for defective materials like the Chinese drywall must be analyzed on a case-by-case basis to determine whether Florida’s pre-suit construction defect statutes apply or if an exception may be involved (such as a related personal injury claim) to avoid the process.

More specifically, property owners who allege construction defects must first notify the construction professional responsible for the defect and allow them an opportunity to repair the defect before the homeowner can bring suit against them. The statute, which allows homeowners and associations to file claims against certain types of contractors and others, defines the type of defects that fall under the authority of the legislation and the types of housing covered in the legislation. The law also establishes strict timeframes for builders to respond to the claims, and once a builder has inspected the unit, the law allows the builder to offer to repair or settle by paying the owner a sum to cover the cost of repairing the defect. The homeowner has the option of accepting the offer or rejecting the offer and filing suit. Under the statute, the courts must abate any homeowner legal action until the homeowner has undertaken the claims process. The broader details of the statute can be found at § 558.004. Recovery efforts may in turn be waylaid for a short period of time in order to ensure compliance with these mandatory procedural requirements.

CONCLUSION

With the emergence of litigation asserting the hazardous nature of Chinese drywall, affected parties will need to become more cognizant of the issues involved to develop a comprehensive strategy to handle these allegations. Parties potentially on notice of possible claims against them would do well to keep abreast for the developing science on this issue by monitoring the current actions against the manufacturers, distributors, and homebuilders in the chain of commerce. For insurers, developing a going-forward strategy in investigating these claims is likely worthwhile to ensure that practices remain consistent and that policy provisions are employed properly. Should a considerable number of such claims materialize, more parties may look to their insurers

for coverage for damages related to these losses. In turn, insurers may look to reinsurance and subrogation actions if coverage is available.

In preparing this paper, Nelson, Levine, de Luca & Horst has sought to canvas, in a comprehensive manner, the potential issues relating to the new and potentially growing concerns relating to Chinese drywall. However, this paper should not be considered an exhaustive treatise on this phenomenon where both scientific and legal investigations continue with respect to the allegations presented. We hope that this paper provides insight into how allegations of substandard Chinese drywall could impact insurance coverage, reinsurance, and subrogation activities of insurers and cautions insurers that, based on the amount of Chinese drywall imported into the United States, these allegations may be asserted in the foreseeable future.