



CHINESE DRYWALL: Background, Scope and Insurance Coverage Implications

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INTRODUCTION

This handout is intended to provide a general overview of what has been termed the “Chinese drywall problem,” and the insurance coverage issues that will likely emerge therefrom. The first section provides a general background of the Chinese drywall problem and includes an overview of the litigation which has arisen from the issue. The second section provides a discussion and analysis of the key insurance coverage issues which are likely to arise in connection with potential first party and third party Chinese drywall claims.

BACKGROUND

In the years 2004 through 2006, the housing boom and the rebuilding efforts necessitated by Hurricanes Katrina, Rita, and Wilma, led to a shortage of construction materials. As a result of this shortage, U.S. builders and suppliers began to import significant amounts of Chinese-manufactured drywall (“Chinese drywall”), estimated by some sources to be enough to construct approximately 100,000 homes.

Starting around 2006, homeowners located in southwest Florida began to complain about the Chinese drywall that had been installed in their homes, asserting that the drywall was emitting a “rotten egg-like” odor and that gases released from the drywall were causing the corrosion of certain metals (specifically, copper, copper alloys and silver) located within their homes. Additionally, homeowners complained about health problems as a result of the “off-gassing.”

The odor and corrosion are generally believed to be caused by the emission of gases from the drywall when certain environmental conditions are present. The specific mechanism and potential dangers related to the Chinese drywall, however, are still being investigated by governmental entities, among others.

THE MAKING OF DRYWALL

Drywall is a widely used construction material that is also commonly known as gypsum board, wallboard, plasterboard, sheetrock, and gyproc. A drywall panel is composed of a layer of hardened gypsum plaster sandwiched between two layers of paper liner. The gypsum used to make drywall can be created both naturally and synthetically.

Mined gypsum is the traditional raw material for drywall. The mineral gypsum is a common sedimentary rock found in abundant deposits throughout the world. Gypsum is a hydrated calcium sulfate, composed of two molecules of water (H₂O) and one of calcium sulfate (CaSO₄). The color of gypsum is transparent to white, although due to impurities, it can sometimes look gray, brown, or pink.

Synthetic gypsum is of the identical chemical structure as the mineral gypsum, and is produced as a byproduct of coal combustion power plants. In most coal combustion power plants, the burning of coal produces undesirable emissions of sulfur. Through the industrial process known as flue gas desulfurization (FGD), synthetic gypsum is created. FGD is a chemical process that utilizes various scrubber systems to remove sulfur oxides from the flue gas of power plants burning fossil fuels. The capture and removal of the sulfur gases is accomplished by combining the sulfur gases with a calcium containing sorbent, generally lime (CaO) or limestone (CaCO₃). The chemical reaction between the calcium containing sorbents and the sulfur dioxide produces calcium sulfate, or gypsum.

When gypsum is crushed and heated to remove approximately seventy-five percent (75%) of its water content, it becomes a fine white powder, known as “Plaster of Paris.” When water is added to this white powder, it results in a paste-like material or slurry. Certain additives are blended with the paste or slurry to form the core of the drywall. Fabrication of the drywall consists of placing this gypsum core material between two sheets of manufactured paper. The core is set, dried, and cut into appropriate sizes.

While gypsum in both its synthetic and natural form has the same basic chemical makeup, CaSO₄ and 2H₂O, the amount and types of trace materials and unreacted sorbents found in the source material can vary among power plants and among mines.

THE CHINESE DRYWALL LAWSUITS

Commencing in January of this year, numerous lawsuits, both individual and class action, have been filed involving the allegedly defective Chinese drywall. With the exception of a few actions initiated by homebuilders, all of the lawsuits have been brought by homeowners. The lawsuits have been filed primarily in Gulf Coast states, with the great majority in Florida and Louisiana.

Generally, the complaints allege that the problem with the Chinese drywall, which was composed of both naturally mined gypsum and synthetic gypsum manufactured from coal combustion byproducts, is that it contains excessive levels of sulfur. As a result of these excessive sulfur levels, when the drywall is subjected to certain environmental conditions, the product emits hydrogen sulfide gas and other sulfide gases. These gaseous emissions (a/k/a “off-gases”) allegedly create a noxious “rotten egg-like” odor reported in many homes, and cause damage and corrosion to home structural and mechanical systems such as air conditioner and refrigerator coils, copper tubing, faucets, metal surfaces, and electrical wiring. Additionally, the chemical compounds are alleged to cause various health problems in individuals including allergic reactions, coughing, respiratory problems, sinus problems, throat infection, eye irritation and nosebleeds. Thus far, the health problems appear to only be temporal issues.

The target defendants in the complaints are various manufacturers, suppliers, and builders. The complaints allege that the defendants’ actions in manufacturing, exporting, importing, distributing, supplying, inspecting, selling, and installing the defective drywall, which was unreasonably dangerous and unsafe, has caused the aforementioned damage to the class plaintiffs’ homes, other property, and has caused the health problems described above. The causes of action asserted against the defendants include negligence, strict liability, breach of express and implied warranties, breach of contract, fraudulent misrepresentation, fraudulent concealment, violation of unfair trade practices statutes, private nuisance, unjust enrichment, and equitable and injunctive relief.

The plaintiffs seek recovery for the costs of inspection, removal and replacement of the drywall, the repair and replacement of other damaged property or items in the homes, and any other materials contaminated or corroded by the drywall. The plaintiffs also seek recovery for the costs associated with moving while their homes are undergoing repairs, the renting of comparable housing during the repair period, loss of use and enjoyment of real property, and the loss in the value of the homes due to the stigma attached to having defective drywall in the home. Additionally, many of the class action complaints that allege health problems seek equitable relief in the form of environmental and medical monitoring for the class.

Manufacturers

The target manufacturers in the lawsuits are Knauf Gips KG, a German building materials manufacturer, and its affiliates, Knauf Plasterboard (Tianjin) Co., Ltd., Knauf Plasterboard (Wuhu) Co., Ltd., and Knauf Plasterboard (Dongguan) Co., Ltd., which are Chinese companies that manufacture gypsum drywall, and Taishan Gypsum Co., Ltd. (f/k/a Shandong Taihe Dongxin Co., Ltd.), a Chinese manufacturer of gypsum drywall.

Distributors and Suppliers

The complaints name a variety of suppliers that have distributed and sold the defective drywall, including Chinese exporter Rothchild International Ltd., and the leading producer of gypsum wallboard in North America, Chicago-based USG Corporation, as well as USG Corporation subsidiary L&W Supply Corporation, d/b/a Seacoast Supply. Additional named suppliers include: Miami-based company, Banner Supply Company; Florida corporations, La Suprema Trading, Inc., La Suprema Enterprise, Inc., and Black Bear Gypsum Supply, Inc.; Louisiana company, Interior & Exterior Building Supply; Georgia corporation, Rightway Drywall, Inc.; and a member owned buying organization, Independent Builders Supply Association, Inc.

Builders

The builders named in the complaints that allegedly used and installed the defective Chinese drywall in the construction of homes include large regional homebuilders, such as: Lennar Corporation, a Miami, Florida headquartered builder that builds homes in 17 states, and its affiliates Lennar Homes, LLC f/k/a Lennar Homes, Inc. and U.S. Home Corporation; Taylor Morrison, Inc. f/k/a Taylor Woodrow, Inc.; Touse Homes, Inc., f/k/a Engle Homes, which operates throughout Florida, the Mid-Atlantic, Texas, and the West; and WCI Communities, Inc., a

Delaware corporation. One complaint also names a smaller Florida homebuilder, South Kendall Construction Corporation.

On June 15, 2009, the Judicial Panel on Multidistrict Litigation (JPML) ordered ten federal actions involving liability for Chinese drywall consolidated in the U.S. District Court for the Eastern District of Louisiana under MDL No. 2047. It was also ordered that another 67 related actions pending in numerous federal districts, as well as any other related action be treated as potential tag-along actions. The consolidation allows one federal judge to manage, *inter alia*, pretrial procedures, discovery, and dispositive motions. Judge Eldon E. Fallon has been appointed to oversee coordination of pre-trial proceedings. Judge Fallon is best known for managing the federal Vioxx products liability litigation proceedings. Following all discovery and pretrial rulings, if issues remain to be tried, the cases will be remanded back to the courts where they were originally filed for trial.

REPORTED CHINESE DRYWALL TESTING

In 2008, environmental consulting firm, Environ International Corp. (“Environ”), hired by a builder Lennar Corporation, conducted tests on some of the Florida homes affected by the allegedly defective Chinese drywall. Reportedly, the tests confirmed that certain Chinese-manufactured drywall was emitting sulfur gases capable of corroding copper air conditioning coils contained in the homes. In testing the air of the affected homes, Environ concluded that the level of the sulfur compounds, carbon disulfide, carbonyl sulfide, and dimethyl sulfide, that were detected were within health and safety limits.

A laboratory located in New Jersey, EMSL Analytical, Inc. (“EMSL”), has also performed independent testing on Chinese-made drywall. EMSL reportedly began its investigation in 2006 following complaints of “rotten egg” odors being emitted from drywall. It ultimately linked the problem to Chinese-made drywall. According to EMSL, the cause of the off-gassing sulfur compounds is impurities in the Chinese-made drywall. Although it is still studying the problem, EMSL has also reported a potential microbiological component in the drywall which may be causing calcium sulfate to degrade into hydrogen sulfide.

Additionally, Knauf Plasterboard (Tianjin) Co. Ltd. hired the Center for Toxicology and Environmental Health, LLC (“CTEH”) to conduct an air quality investigation in Florida homes in 2006. CTEH also detected levels of carbonyl sulfide and carbon disulfide. Knauf Plasterboard (Tianjin) has stated that the levels of the sulfur-containing compounds in the homes are no greater than that found in the air outside homes or in soil, marshes or the ocean.

On March 20, 2009, the Florida Department of Health (“DOH”) released the results of analytical testing it had commissioned of drywall samples, performed by Unified Engineering, Inc. (“Unified”). Unified found strontium sulfide at trace levels in the Chinese-made drywall. Unified further found that the Chinese drywall samples gave off a “distinct sulfur odor” when heated during testing. Unified detected three volatile sulfur compounds, hydrogen sulfide, carbonyl sulfide, and carbon disulfide, from the Chinese-made drywall that had been exposed to moisture conditions similar to that expected in a Florida environment without air conditioning. Unified could not reach a reliable conclusion on the source of the sulfur and indicated further analysis was required. Dr. David Krause, a toxicologist with the Florida Department of Health, stated that because the test only detected small quantities of strontium sulfide, further tests were necessary to determine if it is the cause of the odors and corrosive gases.

Most recently, on May 7, 2009, the U.S. Environmental Protection Agency’s Environmental Response Team published a drywall analysis comparing a limited number of Chinese drywall samples from Florida homes to U.S. made drywall samples purchased from a Home Depot in New Jersey. The EPA found significant differences between the Chinese drywall and the U.S. made drywall. Sulfur was detected in the Chinese drywall but not in the U.S. Drywall. Strontium in the Chinese drywall was anywhere from twice to ten times the amount found in the U.S. made drywall. Iron concentrations in the Chinese drywall were also significantly higher. There was no evidence of fly ash found in the Chinese drywall samples or the U.S. samples.

Presently, none of the organizations investigating Chinese drywall have reached a determination on the specific mechanism of the problems associated with the Chinese drywall and potential dangers. Investigations by the State of Florida, United States Consumer Protection Safety Commission, and U.S. Environmental Protection Agency, among others, continue.

FEDERAL LEGISLATION

Congressional representatives from Florida and Louisiana have been pushing for governmental investigations of the Chinese drywall problem and advancing related legislation. On May 7, 2009, the House of Representatives passed H.R. 1728 Mortgage Reform and Anti-Predatory Lending Act, a bill to reform the mortgage industry. Included in the bill is an amendment [H.AMDT.119], which directs The Secretary of Housing and Urban Development, in consultation with the Secretary of the Treasury, to study the impact of Chinese drywall on residential mortgage foreclosures. On April 14, 2009, a bill was introduced in the House of Representatives by U.S. Representative Robert Wexler (D-FL) [H.R. 1977 Drywall Safety Act of 2009], which would mandate a Consumer Protection Safety Commission (CPSC) study of the Chinese drywall issues and would impose an interim ban on drywall exceeding 5% organic compounds. The bill was referred to the House Energy and Commerce Committee, which has not yet taken any action. On March 30, 2009, Senator Bill Nelson (D-FL) and Senator Mary Landrieu (D-LA) introduced a resolution in the U.S. Senate [S.Res.91] calling on the CPSC, the Secretary of the Treasury, and the Secretary of Housing and Urban Development to take action on issues relating to drywall imported from China. Additionally, both the Senate Committee on Commerce, Science, and Technology, Subcommittee on Consumer Protection, Product Safety, and Insurance, and the Senate Judiciary Committee have recently conducted hearings on Chinese drywall issues.

SCOPE OF THE PROBLEM

Because of the developing nature of the investigations into Chinese drywall, the scope of the problem is still largely unknown. A recent report issued by Navigant Consulting studied data from the U.S. International Trade Commission (USITC), which tracks imports as compiled by the U.S. Department of Commerce. Navigant found that approximately 518 million pounds or 317 million square feet of drywall was imported from China between 2004 and 2008.¹ Navigant then calculated, based on the National Association of Home Builders' calculation that an average home contains 8,740 square feet of drywall, that approximately 36,000 homes could be potentially affected by the Chinese drywall.² Additionally, USITC data confirms that Florida, Louisiana, and California were the largest points of entry for the Chinese drywall, receiving over 76% of total imports from 1999 to 2008.³

Based on litigation filed to date, we know that the allegedly defective Chinese drywall exists in homes located in Florida, Louisiana, Alabama, Mississippi, North Carolina, Georgia, Texas, Ohio and Virginia. Additionally, while the problem appears limited to residential construction at this time, the use of the suspect drywall in commercial construction certainly cannot be ruled out. Moreover, given the material shortage involving U.S. manufactured drywall throughout the country, logic dictates that use of the Chinese drywall was not limited to any specific geographic area. However, testing to date indicates that the release of the sulfur gases from the drywall may be related to the ambient temperature and/or humidity present in the environment. As a result, it is possible that the reported problems associated with the Chinese-made drywall may be mostly limited to locations where this type of environment persists. Forecasts on the breadth of the Chinese drywall problem will likely be shaped by results of additional testing.

CHINESE DRYWALL REPAIR

Although some homebuilders have undertaken to replace the allegedly defective Chinese drywall installed in the homes that they have built, there has been no established peer review protocol for remediation. Some sources have estimated that the cost for replacement of the drywall would be approximately \$100,000 per home. The Florida Professional Coalition for Chinese (reactive) Drywall recently published a protocol for the repair of Chinese drywall damaged structures and contents, however, the total cost associated with this protocol is currently unknown. Efforts in developing protocols are continuing and counterproposals are likely.

¹ Andrea Tecce, Brian Fisher and Mary Lyman, Chinese Drywall Issue and Litigation, 3, Navigant Consulting, July 2009.

² *Id.*

³ *Id.* at 4.

COVERAGE ANALYSIS

In anticipation of first party property and third party liability claims submitted as a result of the Chinese drywall issues, this section provides an analysis of the key insurance coverage issues we believe most likely to recur. As the complaints to date all relate only to residential properties, the following discussion on first party claims focuses on homeowners policies. Additionally, because the vast majority of Chinese drywall lawsuits have been filed in Florida and Louisiana, and most of the plaintiffs, defendants, lawsuits, and alleged damages are connected to these forums, the analysis of coverage issues focuses upon the application of Florida and Louisiana law. Of note, however, the possibility certainly exists that if a particular insurance contract was issued and delivered to an insured's headquarters located in another jurisdiction, a court addressing insurance coverage disputes would likely apply the law of that jurisdiction in resolving coverage issues.

FIRST PARTY PROPERTY CLAIMS

Is there a physical loss of or damage to covered property?

The first step in any analysis of a first-party property insurance claim requires consideration of the policy's coverage grant, usually set forth in the policy's "insuring agreement." Typically, the coverage grant in such a policy will, at a minimum, require physical loss of or damage to covered property during the policy period as a result of an insured peril or covered cause of loss.

In the case of the allegedly defective Chinese drywall, there appear to be four items, or conditions, which policyholders may identify as physical loss or damage: (1) the incorporation of defective suspect drywall into the insured residence premises; (2) the off-gassing of sulfur compounds into the living space, potentially impairing habitability; (3) corrosion and pitting of copper materials (such as wiring, pipes, coils, etc.) within the dwelling; and (4) furniture or other porous items acquiring sulfur odors.

Does Incorporation of Defective Suspect Drywall Into The Dwelling Constitute Direct Physical Loss or Damage?

Courts have recognized that the term "physical loss or damage" strongly implies that there was an initial satisfactory state that was changed by some external event into an unsatisfactory state. *Trinity Indus., Inc. v. Insurance Co. of North America*, 916 F.2d 267 (5th Cir. 1990); *Wolstein v. Yorkshire Ins. Co.*, 985 P.2d 400 (Wash. Ct. App. 1999); *North American Shipbuilding, Inc. v. Southern Marine & Aviation Underwriting, Inc.*, 930 S.W. 2d 829 (Tex. Ct. App. 1996); *see also* 10 Couch On Insurance § 148:46 (3d Ed. 1999) ("the requirement that the loss be 'physical' precludes any claim against the property insurer" when the loss is "unaccompanied by a distinct, demonstrable, physical alteration of the property"). In other words, in order for there to be physical loss or damage to property, a discrete event, usually labeled an accident or occurrence, must lead to physical alteration or damage to insured property such that the function of the property is impaired. That is not the situation with the installation of suspect drywall.

By all reported accounts, the suspect drywall panels were manufactured with sulfur materials in China, long before they were incorporated into the insured residence premises. Consequently, the very condition which (allegedly) would render the drywall defective did not come about by virtue of some external force or event. Rather, it existed prior to the time it was subject to coverage under the policies. This sort of preexisting defect does not constitute insurable "direct physical loss or damage" to covered property.⁴

⁴ Of note, insureds may argue that the drywall did not begin to emit sulfur compounds, resulting in offensive odors and corrosion of copper metal, until impacted by high heat and humidity, which are climate conditions typical to the geographic region where the panels were installed. While some reports, including the March 17, 2009 report prepared for the Florida Department of Health, do confirm that exposure of the "Chinese samples" to "extreme heat and moisture" causes the release of a "sulfur odor," we note that the report describes this condition in terms of "accelerating the release of volatiles from the drywall." Thus, by using the term "accelerating," we understand that the off-gassing is something that was already occurring, perhaps to lesser degree, but occurring nonetheless, before the application of heat and moisture.

Does The Emission of Unpleasant And Potentially Harmful Sulfur-Based Gases, Which Could Impair The Habitability of The Dwelling, Constitute Direct Physical Loss or Damage?

Whether or not the mere incorporation of suspect drywall into the residence premises constitutes direct physical loss or damage to covered property by itself, one of the problems with the drywall is that it allegedly emits sulfur compound gases giving rise to sulfur related odors. The “rotten egg” odor is not “physical” in the conventional sense of the word. The question posed then is whether as a result of those odors the insured premises may be deemed to have sustained a “physical loss.”

A direct physical loss connotes some change in the structure or condition of the property. However, it is clear that property does not necessarily have to be consumed or utterly destroyed or subject to physical damage in the traditional sense in order to constitute “direct physical loss or damage.” In various situations courts have, in fact, concluded that there is physical loss or damage where no typical tangible damage to property has occurred. A series of cases indicate that not only is loss of possession of property sufficient to constitute physical loss or damage, but the phrase “physical loss or damage” may also encompass *loss of the functional use* of insured property, even though it arguably has not been physically lost in the sense that the insured no longer knows where it is, or actually sustained tangible injury. See e.g. *Gibson v. H.U.D.*, 479 F.Supp. 3 (E.D.Pa. 1978); *Hughes v. Potomac Ins. Co.*, 199 Cal. App. 239 (1962).

To date, no Florida or Louisiana cases address the question of whether an odor constitutes physical loss or damage. However, there are cases from other jurisdictions in which courts have found that the presence of odors in a building can constitute physical loss or damage. See *Western Fire Ins. Co. v. First Presbyterian Church* 437 P.2d 52 (Colo. 1968); *Farmers Ins. Co. v. Trutanich*, 858 P.2d 1332 (Or. App. 1993); see also *ColumbiaKnit, Inc. v. Affiliated FM Ins. Co.*, No. Civ. 98-434-HU, 1999 WL 619100 (D. Or. Aug. 4, 1999). Additionally, while not “odor” cases, guidance as to the level and degree of impurity required to constitute a “physical loss” may be found in certain asbestos contamination cases. See e.g. *Port Authority of New York and New Jersey v. Affiliated FM Ins. Co.*, 311 F.3d 226 (3d Cir. 2002) (emphasizing that unless asbestos in a building is in a quantity and condition that makes the structure unusable, there is no compensable “physical loss or damage” under a commercial property policy).

Therefore, to the extent the drywall does emit sulfur-based gases to a point where they can be smelled within the residence, and to the extent where the gases and odors substantially impair the use and enjoyment of the residence, courts would likely conclude that the insured premises as a whole had sustained physical loss or damage. Even if the gases and odors do not physically injure or alter the structure, as a fire or other casualty might, the gases and odors are physical compounds not normally present that can be sensed. In sufficient degree, they can physically impair the intended function of a structure, which is to provide a habitable living space. Furthermore, while people are not insured property under first party coverages, objective evidence of illness or injury due to the presence of sulfur-based gases, or the threat of such illness or injury, would strongly support a finding that the dwelling had sustained physical loss. However, mere subjective concerns about health threats in the future, without scientific and medical support, should not bear on whether the residence has sustained physical loss.

Does Discoloration and Corrosion of Copper Metal Within the Dwelling Constitute Direct Physical Loss or Damage?

A widely reported condition resulting from the installation of suspect drywall is the presence of an accumulated black residue on the surfaces of various copper items within the affected properties. This condition is reported to affect copper materials which include copper wires that are part of the homes’ electrical systems, electrical appliances, brass and other fittings used in furnaces, and copper components of air conditioning units. In many such instances, the black residue is reportedly causing physical damage to the copper materials, which is manifested in the form of pitting and other corrosion.

The mere presence of the reported black residue on copper components likely does not constitute “physical loss or damage.” The condition may be unsightly, and the appearance of the blackened discoloration probably does constitute a physical change in the property, but it also is a condition that can probably be remedied by wiping the affected copper surfaces with a cloth containing a metal cleaner. If testing confirms that the residue can be easily removed without harming the copper, mere discoloration, without more, probably will not satisfy the threshold

requirement of physical loss or damage. See *Mastellone v. Lightning Rod Mut. Ins. Co.*, 884 N.E.2d 1130 (Ohio App. 2008)(holding that mold on the exterior siding of house which could be removed with no harm, did not constitute “physical damage” or “physical injury”).

If, however, further testing confirms that the black residue reported is evidence of active corrosion, and the corrosion damages the metal beyond mere discoloration of the surface, then it would seem more likely that there has been direct physical loss or damage with respect to that property. See, e.g., *McConnell Construction Co. v. Ins. Co. of St. Louis*, 428 S.W.2d 659 (Tex. 1968) (corrosion of copper and other metal surfaces caused by fumes emitted from muriatic acid applied to brick floor in newly-constructed home held to constitute non-excluded loss within grant of coverage in builder’s risk policy).

Finally, it is clear that through-wall corrosion of copper components within an air conditioning unit or a furnace, or any other copper item that actually fails because of corrosion, clearly will constitute direct physical loss or damage to property. Also, to the extent that any furniture, clothing or other porous items become infused with odors strong enough to require washing or other treatment to remove the odor, it is likely that such property will be deemed to have sustained physical damage.

Trigger of Coverage

Because the problem caused by suspect drywall reportedly occurs gradually over time, there may be situations in which it is unclear during which policy period any loss or damage may have occurred, and which policies may be called upon to respond to the claimed loss. Accordingly, “trigger” of coverage may become an issue.

Although no real “loss or damage” can be said to have occurred to the suspect drywall panels simply because they were manufactured with sulfur-containing materials, that condition took place at a discrete, identifiable time -- which was the time of manufacture in China.⁵ Unlike the defective condition of the suspect drywall itself, or the act of incorporating suspect drywall into the dwelling, the loss or damage sustained as a result of the odor and corrosion to copper materials is not something that can be attributed to any one, isolated or identifiable event or occurrence. Rather, to the extent these conditions constitute loss or damage, they very likely will present as conditions of progressive loss or damage that have occurred over a period of time.

In general, courts have held that, in first party progressive loss cases, where the loss occurs over time and is not discovered immediately, the policy on the risk at the time of manifestation of the damage is the policy that is triggered. These cases represent the majority view that the “manifestation rule” is appropriately used in first party coverage cases, rather than the “continuous trigger” rule that is often applied to third party liability cases, because of “fundamental differences” in the “interests protected by the two distinct forms of coverage.” See *Port Authority of New York and New Jersey v. Affiliated FM Ins. Co.*, 311 F.3d 226, 233-234 (3d Cir. 2002). Louisiana courts apply the manifestation rule to progressive loss scenarios under first party property policies. *Liberty Mut. Ins. Co. v. Jotun Paints, Inc.*, 555 F.Supp.2d 686 (E.D. La. 2008) (citing *Oxner v. Montgomery*, 794 So.2d 86 (La.App. 2001); see also, *New Orleans Assets LLC v. Travelers Property Cas. Co.*, 2002 WL 32121257 (E.D. La. 2002) (citing *St. Paul Fire & Marine Ins. Co. v. Valentine*, 665 So.2d 43 (La.App. 1st Cir. 1995; *Korossy v. Sunrise Homes, Inc.*, 563 So.2d 1215 (La.App. 5th Cir. 1995). While the courts of Florida have yet to discuss which trigger to apply to progressive losses under first party property policies, there is no reason to believe they would not adopt the manifestation rule used by the majority of courts.⁶

Under the manifestation rule, coverage is triggered only under those policies in effect when the loss becomes manifest, that is “at that point in time when *appreciable damage* occurs and is or should be known to the insured, such that a reasonable insured should be aware that his notification duty under the policy has been triggered.” *Prudential-LMI Com. Inc. v. Superior Court*, 798 P.2d 1230, 1238 (1990)(emphasis added). Cases from jurisdictions involving progressive mold damage under first party property insurance policies are illustrative. In each of these cases, courts applied a manifestation approach to trigger of coverage. See, *New Orleans Assets, L.L.C. v. Travelers*

⁵ Nor can it be said that there is “physical loss or damage” merely because suspect drywall was used as a building component, which probably also can be traced to a fairly discrete period of time.

⁶ It warrants mention that Florida courts have applied the manifestation trigger in “occurrence” policies. See e.g. *Auto Owners Ins. Co. v. Travelers Cas. & Sur. Co.*, 227 F.Supp.2d 1248 (M.D. Fla. 2002).

Prop. Cas. Co., 2002 WL 32121257 (E.D.La. Sept. 12, 2002) (Manifestation trigger applies to claims for mold growth. There is no coverage although some mold damage was discovered during the policy period, where mold contamination at the insured building first manifested before the policy period).

The manifestation trigger will therefore likely apply to the suspect drywall claims pertaining to odor and corrosion of copper materials. Insureds making odor-based claims may report that the odor was not noticed all at once, but rather was something that they began to notice gradually, with greater intensity, as time spent within the residence increased. This seems to be particularly likely where the odor is reported to be present throughout the residence, and not limited to one or two particular rooms. The discovery of blackened copper materials may present a situation where certain insureds recall the date they first noticed the condition, because most of the copper materials at issue are not of the type, or in a location, where they would be constantly seen. However, corrosion is not something that occurs in an instant, so it, too, will be considered a progressive loss.

What constitutes “appreciable damage” in terms of the odors and visible corrosion presented by the suspect drywall claims is probably a question of degree and will likely be determined on a case-by-case basis depending on the facts of each claim. Nevertheless, it is likely that mere discoloration (*i.e.* corrosion) of copper or other metals would constitute “appreciable damage” to the average insured. Something more, such as widespread corrosion of many metal surfaces with some evidence of pitting would probably be required in order to put the insured on notice of a potential claim. Similarly, transient odors, or continuous odors that are barely detectable to the sense of smell, probably do not qualify as appreciable damage. However, a strong odor that is clearly detectable and which is present for a continuous period of time, such as three days or longer, probably is the type of condition which would put a reasonable insured on notice of claim. The bottom line is that the property insurer who insured the dwelling when such appreciable damage was present will be responsible for providing indemnity, if any, for the odor and/or corrosion conditions.

Exclusions

Assuming that some of the reported conditions that are allegedly due to the suspect Chinese drywall are considered physical loss or damage, a series of exclusions contained in first party property policies may apply to bar coverage. In particular, the exclusions for: (1) inherent vice/latent defect; (2) corrosion; (3) pollution; (4) faulty materials; and (5) dampness or temperature, may have bearing on potential homeowner claims.

Inherent Vice

Generally, first party property policies contain an inherent vice and latent defect exclusion which excludes coverage for “any loss caused by . . . inherent vice . . .” There are no reported cases in Florida or Louisiana that interpret a property policy’s exclusion for damage caused by “inherent vice.” There are, however, a number of widely cited extra-jurisdictional cases that have analyzed and applied the exclusion for “inherent vice,” including the Washington Court of Appeals decision in *Port of Seattle v. Lexington Ins. Co.*, which held as follows:

An inherent vice is defined by various courts as “any existing defects, diseases, decay or the inherent *nature* of the commodity which will cause it to deteriorate with a lapse of time.” It is also defined “as a cause of loss not covered by the policy, does not relate to an extraneous cause but to a loss entirely from internal decomposition or some quality which brings about its own injury or destruction. The vice must be inherent in the property for which recovery is sought.” (citations omitted). In other words, the question is whether the “insured property . . . contain[s] its own seeds of destruction . . . [or whether it] was threatened by an outside natural force.” *American Home Assur. Co. v. J.F. Shea Co., Inc.*, 445 F. Supp. 365, 368 (D.D.C. 1978). (Emphasis added).

Port of Seattle v. Lexington Ins. Co., 48 P.3d 334, 338-39 (Wash. Ct. App. 2002) (holding that Y2K problem was an inherent vice).

The exclusion for “inherent vice” likely will not apply to any potential claim. When used in an exclusion to all risk coverage, the term “inherent vice” does not relate to an extraneous cause but to a loss entirely from internal composition or some quality which brings about *its own* injury or destruction. The vice must be inherent in the property for which recovery is sought. Clearly, the suspect drywall is by definition composed of materials making it prone to off-gassing of noxious chemicals. While that may be a vice or a flaw, or even an inherent vice in one sense

of the term, the internal composition of the suspect drywall apparently does not result in the deterioration or breakdown of the drywall. Therefore, it is unlikely that a court would apply the exclusion to bar coverage for any losses due to the suspect drywall.

Latent Defect

The exclusion further precludes coverage for any loss caused by “latent defect.” In general, “latent defect” is construed to mean a defect that is hidden, or which could not have been discovered by any known or customary test or examination. *City of Burlington*, 190 F.Supp. 2d at 688, citing, *Bd. of Educ. of Maine Twp. High Sch. Dist. v. International Ins. Co.*, 684 N.E. 2d 978 (Ill. App. 1997); *Ariston Airline & Catering Supply Co. v. Forbes*, 511 A.2d 1278 (N.J. Super. 1980). In this case, the sulfur-containing materials incorporated into the suspect drywall can only be detected upon destructive testing done on a sample cut out of the drywall. Accordingly, it is reasonable to conclude that the sulfur materials were not only hidden, but that they could not have been discovered by any known or customary test or examination. See, *General Motors, Inc. v. The Olancho*, 115 F.Supp. 107 (S.D.N.Y. 1965), aff’d, 220 F.2d 278 (2d Cir. 1965) (defect must be undiscoverable by a known or customary test).

The harder question is whether those imperfections can be considered “defects,” as that term is used in the exclusion. As noted in the Florida District Court of Appeal decision of *Egan v. Washington General Ins. Co.*, 240 So.2d 875, 877 (Fla. Dist. Ct. App. 4th Dist. 1970), in order to be a “latent defect” there must be evidence of a defect, defined in the case law as “some structural weakness in the part or component which is responsible for the damage.” The law in Louisiana as to a property policy’s exclusion for property damage caused by “hidden or latent defect” is consistent with Florida law. Specifically, Louisiana courts define latent defect as a “defect that is hidden or concealed from knowledge as well as from sight and which a reasonably customary inspection would not reveal.” See *Nida v. State Farm Fire & Cas. Co.*, 454 So.2d 328, 335 (La.Ct.App.3d Cir. 1984). Moreover, the term “defect,” as used in Louisiana courts, refers to a condition of property rendering it unfit for its intended purpose. *Id.*

Here, the sulfur-containing material incorporated into the suspect drywall is indisputably part and parcel of the structure of the drywall. Thus, the inherent structure of the drywall, which is latent and undetectable absent destructive testing, is arguably responsible for the off-gassing and consequent property damage and, therefore, defective. The structural defects in the suspect drywall, *i.e.*, the off-gassing, manifests once put to its only intended use, which is to serve as a physical barrier and wall component in residences and/or commercial properties. Consequently, because the suspect drywall is structurally defective, *i.e.*, off-gases, once put to its only intended use, and because that defect is latent and only detectable via destructive testing, the exclusions for loss caused by or resulting from “latent defect” should apply to preclude coverage for the suspect drywall claims, including the loss of habitability of the premises due to the presence of odors and gases.

Corrosion Exclusion

Most first party property policies exclude coverage for “the presence of ... corrosion ... however caused” or “any loss caused by . . . corrosion.” The term “corrosion” has not been confined to a wearing away by natural means of weather or the like, or in consequence of conduct of the insured rather than that of an outsider. *Bettigole v. American Employer’s Ins. Co.*, 567 N.E.2d 1259 (Mass. App. 1991). Rather, courts often look to the dictionary term to define the term “corrosion.” *Arkwright-Boston Mfrs. Mut. Ins. Co. v. Wausau Paper Mills Co.*, 818 F.2d 591, 594 (7th Cir. 1987); *Bettigole, supra*; *Adams-Arapahoe Joint School Dist. v. Continental Ins. Co.*, 891 F.2d 772 (10th Cir. 1989); *Lakeshore Marine, Inc. v. Hartford Acc. & Indem. Co.*, 296 S.E.2d 418 (Ga. App. 1982). “Corrosion” has been defined as:

the action, process of effect of corroding; as the action or process of corrosive chemical change not necessarily accompanied by the loss of form; typically a gradual wearing away or alteration by a chemical or electrode chemical oxidizing process; a gradual weakening, loss or destruction.

Wausau Paper Mills Co., 818 F.2d at 594 (quoting, Webster’s Third New International Dictionary (1981)).

Courts have rejected attempts by policyholders to incorporate a temporal requirement into the concept of “corrosion.” Courts across the country uniformly hold that “corrosion” is a physical condition that can occur at any time during the life of the property, and the rate at which the corrosion occurs is generally considered irrelevant.

Moreover, courts consistently reject any contention that language excluding loss caused by “corrosion” encompasses only damage by natural causes. *Bettigole, supra*; *Adams-Arapahoe Joint School Dist., supra*. The law in Louisiana as to a property policy’s exclusion for property damage caused by “corrosion” is consistent with the national trend among a majority of jurisdictions, as set forth above. See *Central Louisiana Elec. Co., Inc. v. Westinghouse Elec. Corp.*, 579 So.2d 81 (La. 1991). To date, no Florida court has interpreted a property policy’s exclusion for property damage caused by “corrosion.” Consequently, without any decisions to the contrary, the law espoused by a majority of jurisdictions is persuasive in relying on the “corrosion” exclusions for the presence of corrosion or for property loss or damage caused by “corrosion” in Florida.

Because corrosion has been identified as the cause of the disintegration and pitting of copper metals at the insured properties, and because well-established case law reflects a common understanding that the term “corrosion” and exclusion for loss caused by “corrosion” concerns “a destruction and a disintegration of metal caused by chemical fumes and a resultant degenerative reaction adversely affecting the structure of metal,” see e.g., *McConnell Constr., supra*, the corrosion of copper metals at the properties is likely excluded from coverage under the policies. *The Bettigole, Metropolitan Waste* and *Central Louisiana* cases further instruct that where corrosion is determined to be the cause of a loss, courts will apply the “corrosion” exclusion and will not permit insureds to mischaracterize the cause of loss as a “secondary cause,” or in some other fashion designed to evade the clear intent of the exclusion.

The plain language of the “corrosion” exclusion further precludes coverage for any property damaged as a result of the corrosion. For example, if the corroded electrical wiring causes electrical failure within the dwelling, or if the corroded copper air conditioning coils causes AC units to malfunction or the eventual discharge and escape of Freon, such resulting property damage to the electrical system and AC unit is excluded as well, because it results from and is proximately caused by the corrosion.

Pollution Exclusion

In general, pollution exclusions in first party policies have been enforced. See e.g. *Brown v. American Motorist Ins. Co.*, 930 F.Supp. 207 (E.D. Pa. 1996)(finding that insureds’ claim that their property became uninhabitable after a chemical waterproofing sealant was applied to exterior of home fell squarely within the pollution exclusion).

The general case law supports the conclusion that the off-gassing of sulfur-containing compounds from the suspect drywall “contaminated” or “polluted” the air within the insured dwellings, thereby triggering the exclusions for loss caused by “pollutants.” The off-gassing rendered the air within the dwellings impure; it contaminated the otherwise clean air. The sulfur-containing compounds constituted a gaseous “irritant,” since they allegedly caused an irritability of eyes and throats, headaches, and nosebleeds, among other things, of homeowners who breathed the contaminated air.

No reported Louisiana cases discuss proper application of a property policy’s exclusion for loss or damage caused by the discharge or release of “pollutants.” Consequently, the law espoused by a majority of jurisdictions is persuasive as to whether an insurer may properly rely on the pollution exclusion. One caveat is worth mentioning. It is well-established in Louisiana that pollution exclusions contained in *liability* policies (including CGL policies and the liability portion of homeowner’s policies) are only intended to exclude coverage for active, industrial, environmental polluters when such businesses knowingly emit pollutants over extended periods of time. See *Thompson v. Temple*, 580 So.2d 1133 (La.Ct.App.4th Cir. 1991); *Grefer v. Travelers Ins. Co.*, 9191 So.2d 758 (La.Ct.App. 5th Cir. 2005). Thus, it is likely the insureds will seize on this limitation concerning insurers’ reliance on the pollution exclusion, even though this claim is a first party claim and the limitation has never been applied by a Louisiana court in the first party context.

Therefore, while Louisiana’s limitation on application of the pollution exclusion to industrial or environmental pollution has never been applied in the first party context, it is, nevertheless, possible that a Louisiana court may adopt this limitation as to first party coverage claims concerning the suspect drywall. Despite these possibilities, and in the absence of any first party decision in Louisiana to hold otherwise, the law espoused by a majority of jurisdictions remains persuasive and supports an insurers’ reliance on the pollution exclusion.

One decision has addressed the proper application of a property policy's exclusion for loss or damage caused by the discharge or release of “pollutants” under Florida law, *Florida Farm Bureau Ins. Co. v. Birge*, 659 So.2d 310

(Fla.Ct.App. 2nd Dist. 1994). In *Birge*, the court found the pollution exclusion inapplicable to damage caused by the back-up of raw sewage. The court determined that the term “pollutant,” which was undefined in the policy at issue, was ambiguous and, therefore, should be construed against the insurer. The court’s determination of ambiguity arguably rested on the fact that the term “pollutant” was undefined, unlike the majority of first party property policies, which define the term. Consequently, the court’s reasoning in finding the *Birge* policy ambiguous draws no support under policies wherein a definition is provided and does not forestall reliance on the exclusion to preclude coverage for the suspect drywall claims. It is also worth noting that, unlike the law of Louisiana in liability matters, Florida law does not limit application of the exclusion for loss or damage caused by the discharge of “pollutants” to losses involving industrial and/or environmental pollution. See *Philadelphia Indemnity Ins. Co. v. Yachtsman’s Inn Condo Ass’n, Inc.*, 595 F.Supp.2d 1319 (S.D. Fla. 2009) (examining CGL policy under Florida law); *Nova Cas. Co. v. Waserstein*, 24 F.Supp.2d 1325 (S.D. Fla. 2006) (same).

Faulty Materials Exclusion

While the incorporation of sulfur-based compounds into the suspect drywall, which ultimately off-gasses once exposed to heat and moisture, has been identified as the likely cause of the suspect drywall problems bears on application of the inherent vice and/or latent defect exclusions in the policies, this finding also necessarily triggers the first party property policies’ “faulty materials” exclusion.

Generally, first party property policies do not cover losses caused by faulty “materials used in repair, construction, renovation or remodeling.” While there are few cases addressing what constitute “faulty materials,” at least one case is instructive. In *Falcon Products, Inc. v. Insurance Co. of the State of Pa.*, 615 F.Supp. 37 (E.D. Mo. 1985), *aff’d*, 782 F.2d 779 (8th Cir. 1986), a scrap metal dealer purchased parts of a medical teletherapy unit. During delivery of the unit to the scrap yard, a capsule housing cobalt pellets ruptured and contaminated, among other things, the scrap metal. Some of this contaminated scrap metal was subsequently purchased and used to produce table bases, during which process a buyer was injured through his contact with the metal. The bases were later recalled after it was determined they were contaminated and, therefore, unusable. Under these facts, the court found that the “faulty materials” portion of the policies’ exclusions applied. In so doing, the court found that, even if the contamination exclusion were not to apply, that would be irrelevant to the question of whether the “faulty materials” exclusion would apply. As the court explained, “if material is faulty, the cause thereof is irrelevant.” 615 F.Supp. at 39.

Here, the sulfur-containing material incorporated into the suspect drywall is similarly faulty and, therefore, unusable in that it allegedly exudes potentially harmful or at least foul smelling sulfur compounds once exposed to heat and humidity, a quality neither expected nor desired by the consumer. Webster’s Dictionary defines “faulty” as something “containing faults, blemishes, or defects,” or something that is “defective” or “imperfect.” The drywall is clearly “imperfect,” since “perfect” drywall does not off-gas noxious and potentially harmful odors. As a result, the exclusion for loss caused by “faulty materials” may well preclude coverage for the drywall, as well as the odor and corrosion attributed to the drywall.

Dampness or Temperature Exclusion

Heat, humidity and/or moisture have been identified as “accelerating” the release of the sulfur compounds from the drywall. Should heat, humidity and/or moisture be identified as a cause of the suspect drywall problems, loss or damage springing from these conditions should be excluded by a homeowners policy exclusion for loss caused by dampness or changes in temperature. This exclusion takes on special significance in the context of ensuing loss, discussed more thoroughly below. For example, policyholders could argue that while the sulfur compounds incorporated in the drywall may be the root of the suspect drywall claims (which is arguably a precluded cause of loss under the Policies’ “inherent vice,” “latent defect,” and/or “faulty materials” exclusions), the off-gassing of the drywall caused by exposure to heat, humidity and moisture may be a separate, intervening cause removing consequent loss or damage from the realm of these particular exclusions. The policies’ exclusion for dampness and changes in temperature effectively forestalls this argument.

There are no Florida or Louisiana decisions addressing this type of exclusion. However, extra-jurisdictional cases have. In *40 Gardenville, LLC v. Travelers Property Casualty of Am.*, 387 F.Supp.2d 205, 213-14 (W.D.N.Y. 2005), the court held that an “air dampness” exclusion precluded coverage for mold contamination, since mold can only

proliferate when dampness exists in the air. The court explained that the term “dampness,” although not defined in the policy at issue, was defined by Merriam-Webster Dictionary as “wetness” or “moistness” and, therefore, “air dampness” can only mean “wetness” or “moistness” in the air, *i.e.*, humidity.

Because the concepts of heat and humidity, which may have played a role in or caused the off-gassing from the suspect drywall, involve air dampness and temperature changes within the insured dwelling, a strong argument can be made that the exclusion applies and precludes coverage for any and all loss stemming from the action of heat and moisture.

Ensuing Loss Exception

Generally, policy exclusions for loss caused by “inherent vice,” “latent defect,” “corrosion,” “pollutants,” “faulty materials,” and “dampness or temperature changes” are each subject to an exception to the exclusions providing that the policies insure ensuing covered losses, unless another exclusion applies.

As detailed above, each category of problems potentially complained of by homeowners, including: (1) pitting and corrosion of copper materials within the dwelling; (2) furniture and other porous materials that acquire a sulfur odor; (3) odor emitted from the drywall; and (4) the damaged drywall itself, is directly caused by one or more excluded causes of loss. Consequently, under the facts and circumstances as we presently understand them, there is no “ensuing” loss. That is not to say, however, that such a loss is not possible. As alluded to at various points in this analysis, there may be instances when “ensuing” loss springing from a covered cause of loss occurs. For now, however, no such factual scenario has presented itself.

For coverage to exist under the ensuing loss exception, an excluded cause must be followed by an independent and distinct peril which is otherwise covered under the policy. *See, Holland v. Breaux*, No. Civ.A. 04-3028, 2005 WL 3542899 (E.D.La. 2005) (applying Louisiana law); *Swire Pac. Holdings, Inc. v. Zurich Ins. Co.*, 845 So.2d 161, 167 (Fla. 2003). Therefore, where, as in the drywall cases, no subsequent, distinct and covered peril occurs, the damages are not covered under the ensuing loss exception.

The critical component in an ensuing loss analysis is a determination as to whether an excluded cause is followed by an independent and distinct peril otherwise covered under the policy. A clear example of an “independent and distinct peril” is best described in the context of the exclusion for loss or damage caused by “corrosion.” The “corrosion” exclusion precludes coverage for that property actually corroded, which, in the suspect drywall claims, consists of corrosion to copper wiring, copper air conditioning coils, and/or copper pipes. The language of the exclusion further precludes coverage for any property damaged as a result of the corrosion. In other words, if the corroded electrical wiring causes electrical failure within the dwelling, or if the corroded copper air conditioning coils causes the AC unit to malfunction, such resulting property damage to the electrical system and AC unit is, nevertheless, excluded as resulting from and proximately caused by the corrosion. If, however, the electrical failure and AC unit malfunction caused by the corrosion sets in motion a fire loss due to electrical failure, then the ensuing loss provision would be triggered, since such an event, and consequent property damage, may be classified as an intervening loss caused by a separate and independent occurrence.

THIRD PARTY LIABILITY CLAIMS

Is There an Occurrence?

As a general matter, comprehensive general liability (“CGL”) policies afford coverage for claims against an insured for property damage or bodily injury caused by an “occurrence.” CGL policies generally define the term “occurrence” as an “accident, including continuous or repeated exposure to substantially the same general harmful conditions.” Nevertheless, many of those same policies do not further define the word “accident.”

Courts interpreting Florida law have provided the following guidance in determining if a particular underlying claim is covered when a CGL policy does not define the term “accident:”

“[W]here the term ‘accident’ in a liability policy is not defined, the term...encompasses not only ‘accidental events,’ but also injuries or damage neither expected nor intended from the standpoint of the insured.” *State Farm Fire & Cas. Co. v. CTC Dev. Corp.*, 720 So.2d 1072, 1076 (Fla. 1998). “In many

cases the question of whether the injury or damages were unintended or unexpected will be a question of fact; in some cases, the question will be decided as a matter of law, such as in cases where the insured's actions were so inherently dangerous or harmful that injury was sure to follow."

Assurance Co. of Am. v. Lucas Waterproofing Co., 581 F.Supp. 2d 1201, 1208 (S.D. Fla. 2008); see also *Essex Buildings Group, Inc. v. Amerisure Ins. Co.*, 429 F.Supp.2d 1274, 1287 (M.D.Fla. 2005)(general contractor's insurer failed to demonstrate that an "occurrence" did not take place, given the fact that the alleged water damage to apartment buildings was arguably accidental in the sense that it was not expected nor intended from the insured's viewpoint). The Florida Supreme Court recently reiterated these principles in *U.S. Fire Ins. Co. v. J.S.U.B., Inc.*, 979 So.2d 871 (Fla. 2007), holding that defective work alone could constitute an occurrence. Because the underlying Chinese drywall complaints allege both defective work and secondary injury and damage (to persons and to property), these complaints likely allege an "occurrence" under Florida law.

Louisiana courts have provided conflicting analyses of the meaning of the term "occurrence" in CGL policies. Recently, Louisiana courts have held that defective workmanship, or the incorporation of defective materials, constitute an accident. See, e.g., *Thibodaux v. Arthur Rutenberg Homes, Inc.*, 928 So.2d 80, 87-8 (La.Ct.App. 2005); *Rando v. Top Notch Properties, L.L.C.*, 879 So.2d 821, 833 (La.Ct.App. 2004); *Fontenot v. One Beacon Am. Ins. Co.*, No. 03 1960, 2005 WL 1788251 at *6 (W.D. La. July 27, 2005). In view of these cases, and in view of the fact that the underlying defective drywall claims allege damage to persons and property beyond the installed product, Louisiana courts would also likely find an occurrence for insurance coverage purposes.

Based upon the facts gleaned from the underlying allegations asserted against target defendants to date, it seems certain that, for insurance coverage purposes under the terms of the typical general liability policy there has been an alleged "occurrence." Obviously, each case will develop on its own merits; however, it appears that the bodily injuries and secondary property damage caused by the incorporation of defective Chinese drywall will be deemed unintended and unexpected from the standpoint of manufacturers, builders and suppliers, and therefore an accident. Having said that, discovery in the underlying cases may yield information or documents that suggest otherwise. For example, facts may show the lack of an occurrence on the part of a manufacturer that had some particular knowledge regarding the defective condition of drywall sold to unsuspecting suppliers and/or builders. However, there remains no reason at this juncture to conclude that there has not been an "occurrence."

Did the Alleged Bodily Injury or Property Damage Occur During the Policy Period?

Once it is determined that there is "bodily injury" or "property damage" caused by an "occurrence," it must be determined which potentially applicable policies are "triggered." Generally, coverage is triggered under a CGL policy on the date when the bodily injury or property damage actually occurs. Florida and Louisiana courts follow the general rule that the event that triggers potential coverage under an occurrence policy is the sustaining of actual damage. See *Assurance Co. of Am. v. Lucas Waterproofing Co.*, 581 F.Supp.2d 1201 (S.D. Fla 2008); *St. Paul Fire & Marine Ins. Co. v. Valentine*, 665 So.2d 43 (La. Ct. App. 1995).

When an injury or property damage occurs at a precise point in time, such as the result of a fire, explosion, water pipe burst, or weather event, determining whether the injury or damage occurred during a particular policy period can usually be made with little difficulty. However, the date of trigger of coverage is not so easily ascertained when the injury or damage is progressive or latent in nature. In the context of the Chinese drywall claims, the alleged bodily injuries and property damage do not appear to be attributable to one isolated or identifiable event. Rather, although the specific processes are still unknown and continue to be studied, the bodily injuries and property damage appear to result from continued or repeated exposure to off-gassing sulfur compounds occurring over a period of time. As a result, trigger of coverage will likely be an important issue in the Chinese drywall third party claims, and is an issue which will be dependent on the specific jurisdiction (and often the facts of each individual case).

Although Florida case law is not completely settled with respect to which trigger theory would be applied in the context of progressive bodily injury or property damage cases, it appears that a Florida court would most likely apply either the "injury-in-fact" or "continuous trigger" theory. See *Trizec Properties, Inc. v. Biltmore Constr. Co.*, 767 F.2d 810 (11th Cir. 1985)(The Eleventh Circuit, applying Florida law, appeared to apply an "injury-in-fact" theory, finding that the potential for coverage is triggered when the damage itself occurs (injury-in-fact) during the

policy period, and that it is not required that the damages manifest themselves during the policy period.); *but compare CSX Transp., Inc. v. Admiral Ins. Co.*, 1996 U.S. Dist. LEXIS 17125 (M.D. Fla., Nov. 6, 1996) (the court noted the existence of substantial authority suggesting that a continuous trigger theory would be applied in most jurisdictions under similar circumstances, but due to an agreement amongst the parties and the fact that the two theories appeared to be functionally equivalent under the circumstances, the court adopted the injury-in-fact trigger of coverage).

Under either the “injury-in-fact” or “continuous trigger” theory, Chinese drywall claims would trigger those insurance policies in effect when actual damage or bodily injury occurred. If, as is now largely assumed, the defective drywall began to emit sulfur gas shortly after installation into a home, and progressed until the drywall was replaced or removed, multiple policy periods will be triggered. However, if there are allegations contained in the underlying complaint that humid conditions at a particular time triggered the sulfur emissions, the occurrence date(s) may be limited to that time period.

Louisiana courts have generally applied an exposure trigger to progressive bodily injury claims and long-term contamination cases. *See Norfolk S. Corp. v. California Union Inc.*, 859 So. 2d 201 (La. Ct. App. 2003) (applying exposure trigger to long-term environmental damage as a result of discharges from a wood treatment facility); *Cole v. Celotex Corp.*, 599 So.2d 1058 (La. 1992) (applying exposure theory to bodily injury claims from progressive disease, asbestosis); *Liberty Mut. Fire Ins. Co. v. Ravannack*, No. Civ.A. 00-1209, 2004 WL 722440 (E.D. La. Mar. 31, 2004) (applying exposure trigger of coverage to a claim for bodily injury due to continuous exposure to mold); *but compare James Pest Control v. Scottsdale Ins. Co.*, 765 So.2d 485 (La. Ct. App. 2000) (finding that effects of the termite infestation in condominiums did not become “damage” until the homeowners discovered it). As a result, in determining which policies are triggered, courts applying Louisiana law will look to when injured persons and damaged property were allegedly exposed to the drywall’s sulfur off-gassing.

Montrose Endorsement

CGL policies commonly include an endorsement known as a “Montrose endorsement.”⁷ Under such an endorsement, coverage will cease for all subsequent policies once the insured learns of the continuing injury or damage. In the case of the Chinese drywall claims, it remains unclear specifically when the manufacturers, suppliers, or builders first became aware of the alleged damages. However, as these facts are developed, it may be possible to demonstrate that some policies provide no coverage based on the “Montrose” or “Known Injury or Damage” endorsement. Certainly, now that various complaints have been filed, those named defendants possess knowledge of the continuing injury and damage.

Is Coverage Barred by the Pollution Exclusion?

The majority of general liability policies that will be triggered by Chinese drywall claims will likely include an “absolute” or “total” pollution exclusion. The absolute pollution exclusion, in general, excludes coverage in cases of bodily injury or property damage which would not have occurred but for the discharge of pollutants at any time. Florida and Louisiana courts have interpreted absolute pollution exclusions, with very different results. In short, although Florida law would afford a strong argument that Chinese drywall claims are barred by the pollution exclusion, Louisiana law would not. The applicability of the pollution exclusion will of course ultimately depend on the language of the exclusion, the scientific processes behind the damages, and jurisdiction.

Florida courts have analyzed and applied pollution exclusions in contexts analogous to those presented by the defective Chinese drywall lawsuits. For example, in *Deni Assocs. of Fla., Inc. v. State Farm Fire & Cas. Ins. Co.*, 711 So.2d 1135 (Fla. 1998), the Florida Supreme Court found that the absolute pollution exclusions contained in CGL policies (pursuant to a certified question in two cases) were unambiguous and precluded coverage with respect to bodily injury claims arising out of: (1) alleged indoor air contamination due to an accidental ammonia spill that occurred in a commercial office building; and (2) alleged accidental spraying of insecticide on bystanders standing on property adjacent to a citrus grove being aerially sprayed. Courts applying Florida law have followed the principles enunciated in *Deni* in the context of applying pollution exclusions. *See Auto Owners Ins. Co. v. City of*

⁷ This ISO endorsement is commonly referred to as a “Montrose” or “anti-Montrose” endorsement because it was developed in response to a California Supreme Court decision -- *Montrose Chemical Corp. v. Admiral Ins. Co.*, 10 Cal.4th 645 (1995).

Tampa Hous. Auth., 231 F.3d 1298 (11th Cir. 2000)(CGL insurer was not obligated to defend nor indemnify an insured with respect to an underlying lawsuit for injuries sustained by ingesting and inhaling lead); *Nova Cas. Co. v. Wasserstein*, 424 F.Supp.2d 1325 (S.D. Fla. 2006)(the plain meaning of the definition of the word “pollutant,” contained in an absolute pollution exclusion, included “living organisms,” “microbial populations,” “microbial contaminants,” and “indoor allergens”).

Based upon the *Deni* case decided by the Florida Supreme Court, and its progeny, a persuasive argument exists that the absolute pollution exclusion would operate to exclude coverage for the underlying Chinese drywall claims under Florida law.

In *Doerr v. Mobil Oil Corp.*, 774 So.2d 119 (La. 2000), clarified, 782 So.2d 573 (La. 2001), the Louisiana Supreme Court provided an in depth analysis of the history of the interpretation of pollution exclusions by Louisiana courts, and held that the absolute pollution exclusion excludes coverage for environmental pollution, and will not be applied to all contact with substances that may be classified as pollutants. *Doerr*, 774 So.2d at 134-35. In adopting this approach, the *Doerr* court stated that the “applicability of a total pollution exclusion in any given case must necessarily turn on several considerations,” which the court outlined as follows: 1) Is the insured a “polluter?”; 2) Is the injury-causing substance a “pollutant?”; 3) Was there a “discharge, dispersal, seepage, migration, release or escape” of a pollutant by the insured? The principles announced in *Doerr* places a burden on insurers to provide a sufficient factual basis to support the insurer’s burden of establishing the applicability of a pollution exclusion. See, e.g., *State Farm Fire & Cas. Co. v. M.L.T. Constr. Co.*, 849 So.2d 762 (La.Ct.App.), writ denied, 857 So.2d 483 (La. 2003)(total pollution exclusion did not preclude coverage under a CGL policy for claims by an office worker alleging personal injuries due to exposure to rainwater, mold, mildew and other allergens in a building as a result of water intrusions due to a leaking roof); *Gaylor Container Corp. v. CNA Ins. Co.*, 807 So.2d 864 (La.Ct.App.), writ denied, 803 So.2d 31 (La. 2001), reconsideration denied, 806 So.2d 664 (La. 2002)(pollution exclusions did not preclude coverage for a chemical company in connection with an explosion of a railcar that contained chemicals; the exclusion was designed to exclude coverage for environmental pollution, not to exclude coverage for routine accidents that incidentally involved a chemical agent).

Under Louisiana law, insurers will likely encounter difficulty in relying on the absolute pollution exclusion to exclude coverage for the underlying Chinese drywall claims. The most significant hurdle concerns Louisiana’s approach (in applying such an exclusion), which would not bar coverage for insureds who are not traditional, heavy environmental polluters. For example, many of the target defendants in the Chinese drywall cases are contractors, builders, and suppliers whose business operations do not involve handling or supplying traditional pollutants. While unlikely, it is possible, depending upon the particular circumstances at issue, that a drywall manufacturer could be deemed a polluter under the *Doerr* test – and as a result, the allegations of any underlying complaint filed in Louisiana should be carefully reviewed with the *Doerr* factors in mind.

The Business Risk Exclusions

The notion that CGL policies are intended to insure bodily injury and property damage caused by the insured’s activities, but not the fitness of the insured’s work, is embodied in the provisions commonly referred to as the “business risk” exclusions. Here, because much of the alleged damage and injury is ancillary to the insured’s own work, these exclusions will likely have only limited benefit to an insurer.

Exclusions j.(5) and j.(6)

Besides being limited to the particular work that was incorrectly performed, the operation of exclusions j.(5) and j.(6) only apply in instances in which property is damaged while the insured is actually performing the work at issue. See, e.g., *American Equity Ins. Co. v. Van Ginhoven*, 788 So.2d 388 (Fla. Dist. Ct. App. 2001)(finding exclusions j.(5) and j.(6) to be clear and unambiguous, the court held that the claim was excluded because it concerned what the insured was working on when the damage occurred); *McMath Constr. Co. v. Dupuy*, 897 So.2d 677 (La. Ct. App. 2004)(exclusions j.(5) and j.(6) did not apply because the property damage occurred when the subcontractor’s work was complete).

Here, the alleged damage to the property within the homes (such as damage to air conditioner and refrigerator coils, copper tubing, faucets, electrical wiring, etc.) does not appear to have occurred while work was being performed. Moreover, the claimed damages are not limited to the drywall work itself. As a result, exclusions j.(5)

and j.(6) are not likely to have any impact on coverage for the claims at issue in the underlying Chinese drywall litigation.

Exclusion k. – “Your Product” Exclusion

The “product” exclusion unambiguously excludes coverage for damage to an insured’s product itself or for repair or replacement of the insured’s defective product. *McMath Constr. Co. v. Dupuy*, 897 So.2d 677, 682 (La. Ct. App. 2004) (finding that because there was no physical damage to other property, only the subcontractor’s work or product, the “product” exclusion unambiguously precluded coverage). Additionally, many policies contain an exception to this exclusion for “real property.” Significantly, the real property exception to this exclusion has been found to include buildings. See, e.g., *Dublin Bldg. Sys. v. Selective Ins. Co.*, 874 N.E.2d 788 (Ohio Ct. App. 2007) (“the term ‘real property’ is generally recognized as including both land and the structures affixed thereto”).

As a result, the “product” exclusion will likely have a minimal impact on coverage for the Chinese drywall claims. Although it may apply to preclude coverage for the repair or replacement of the defective drywall as applied to the defendant manufacturers and suppliers, it will likely not apply to preclude coverage for any claims against builder defendants -- because their product is “real property.” Perhaps most importantly, the “product” exclusion will not eliminate coverage for the claims involving bodily injury or damage sustained to property other than the Chinese drywall, i.e., the corrosion to the structural and mechanical systems, and other items in the homes.

Exclusion l. – “Your Work” Exclusion

The primary purpose of the “your work” exclusion is to preclude liability coverage for an insured’s own faulty workmanship and materials. See *North Am. Treatment Sys., Inc. v. Scottsdale Ins. Co.*, 943 So.2d 429 (La. Ct. App. 2006); *Auto-Owners Ins. Co. v. Pozzi Window Co.*, 984 So.2d 1241 (Fla. 2008). Importantly, the “your work” exclusion generally contains an exception for work performed by a subcontractor. As a result, the exclusion does not apply if the damaged work, or the work out of which the damage arises, was performed by a subcontractor.

This exclusion is unlikely to have a significant effect on coverage for the Chinese drywall claims. The exclusion will not apply to the defendant suppliers or manufacturers because the focus of the exclusion is on the installation of the drywall. Moreover, because of the subcontractor exception, the exclusion will usually be inapplicable to the defendant builders. Finally, because of the limited operations performed by insured drywall contractors, this exclusion will most likely only exclude the repair work related to the defective drywall itself.

Exclusion m. – “Impaired Property” Exclusion

The “impaired property” exclusion only excludes damage to property that has not been physically injured or for which the claimed damages are only for loss of use of that property. *Gaylord Chemical Corp. v. Propump, Inc.*, 753 So.2d 349 (La. Ct. App. 2000). Furthermore, the exclusion only bars coverage when the claimants’ property can be restored to use by repair or replacement of the policyholder’s product or work and does not eliminate coverage for those situations in which a third party’s property is damaged because of the existence of the insured’s product or work. See *North Am. Treatment Sys., Inc. v. Scottsdale Ins. Co.*, 943 So.2d 429 (La. Ct. App. 2006); *Transcontinental Ins. Co. v. Ice Sys. of Am., Inc.*, 847 F.Supp. 947 (M.D. Fla. 1994).

The underlying drywall claims allege the loss of use of the claimants’ homes. However, physical damage occurring to the homes resulting from the defective drywall is also alleged. Moreover, the mere removal of the defective drywall will not restore the homes. As a result, this exclusion is not likely to apply to limit coverage as to any of the defendants.

Exclusion n. – Sistership Exclusion

Known as the “sistership” or “product recall” exclusion, this exclusion eliminates coverage for those damages incurred for the replacement or removal of the insured’s product or work if the product is withdrawn or recalled “from the market” because of a known or suspected defect in the product. See *Stoute v. Long*, 722 So.2d 102 (La. Ct. App. 1998); *Champion v. Panel Era Mfg. Co.*, 410 So.2d 1230 (La. Ct. App. 1982). The sistership exclusion only applies in cases where, because of the actual failure of the insured’s product, similar products are withdrawn from use to prevent the failure of these other products that have not yet failed but are suspected of containing the same defect. *Harris Specialty Chems, Inc. v. U.S. Fire Ins. Co.*, 2000 U.S. Dist. Lexis 22596 (M.D. Fla. July 7, 2000)

(holding that a sistership exclusion did not apply when there was no recall or remedial measures taken with respect to buildings that had not yet sustained discoloration of their exterior as a result of the defective product). It does not exclude from coverage damage already caused to the property of a third party.

At present, the “sistership” exclusion appears to have no effect relating to coverage for the Chinese drywall claims. Although there has been a push by legislators from Florida and Louisiana for recall legislation, to date, there has been no withdrawal or recall of the drywall from the market by any defendant manufacturer, supplier, or builder. Therefore, no damages have been incurred associated with the withdrawal or recall of the drywall. Moreover, in the event that a recall does eventually happen, the damages already caused by the defective drywall will remain covered.

The Contractual Liability Exclusion

Another aspect of coverage related to defective Chinese drywall claims under a standard CGL policy concerns the concept of liability coverage for an insured’s contractual liability. Business entities, such as subcontractors, contractors, and/or developers, often times will assume certain liabilities of another business organization through the terms of a written contract, or an indemnity or hold harmless agreement. Typically, CGL policies exclude coverage for claims involving situations in which an insured assumes the liability of another under a contract or an agreement.

Bodily injury and property damage claims arising out of the alleged problems associated with defective Chinese drywall may impact the contractual liability coverage afforded under general liability policies. Both Florida and Louisiana courts recognize that contractual liability exclusions do not always operate to preclude coverage for all underlying claims. *See, e.g., Florida Mun. Power Agency v. Ohio Cas. Ins. Co.*, 714 So. 2d 660 (Fla. Dist. Ct. App. 1990); *Alwell v. Meadowcrest Hosp., Inc.*, 971 So. 2d 411 (La. Ct. App. 2007); *Broadmoor Anderson v. National Union Fire Ins. Co. of La.*, 912 So. 2d 400 (La. Ct. App. 2005), *writ denied*, 925 So. 2d 1239 (La. 2006).

Determining whether, and to what extent, contractual indemnity coverage exists will require a thorough review of the terms of contractor agreements and a critical analysis of the terms of the particular policy at issue.

CONCLUSION

Based on what is known to date, it is clear that the Chinese drywall problem will have a significant impact on both the liability and property insurance industries and warrants close monitoring.

The foregoing discussion and analysis is intended to provide an outline for prospective insurance claims and coverage litigation associated with Chinese drywall. Specific decisions as to coverage issues will require review of each claim on the basis of its own facts and circumstances.

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