

Risk

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The Gathering Storm: Climate-Related Disclosures Creating Increased Risk For Corporate Policyholders

By Ty Childress

Public companies continue to face increasing pressure to make disclosures regarding climate change impacts to their businesses and their "carbon footprints." Investor pressure has become increasingly more aggressive and sophisticated, bolstered by advocacy groups who have created a cottage industry in using companies' proxy seasons to pursue a wide variety of climate change resolutions. The Securities and Exchange Commission has also come under increasing political pressure to adopt regulations which would require companies to disclose climate change risks in their financial reports. Within the past few months, SEC officials have publicly announced their intention to promulgate new regulations in this area.

The summer of 2009 was filled with news of major investor groups, including large pension funds and other institutional investors, pressuring the SEC to require companies to make more detailed

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climate change disclosures in securities filings. Global accounting firms, already having experience in Europe with greenhouse gas emissions and carbon trading issues, and sensing a lucrative opportunity for similar work in the United States, have begun proposing new disclosure “standards.” Environmental advocacy groups trumpeted multiple shareholder resolution victories during the 2009 proxy season, which included dozens of major U.S. corporations agreeing to varying voluntary climate-related disclosures and initiatives.

Against the backdrop of this investor and political activity, boards of public companies are faced with a delicate balancing act of dealing with a lack of specific mandated guidance from the SEC while responding to increasing investor pressure to make voluntary disclosures. Voluntary disclosures, if they turn out to be inaccurate or incomplete, could expose a company to litigation over any such disclosures. Companies can be confident that even the most well-intentioned inaccurate disclosure will not go unpunished as the shareholder plaintiff bar will pounce at any opportunity.

In light of these emerging issues, public companies are well-advised to take steps to evaluate the interplay of their disclosure decisions with their directors’ and officers’ (D&O) liability insurance coverage. Insurers have

Corporate policyholders can expect their insurers to engage in “creative” arguments to avoid covering climate-related securities litigation.

become increasingly aggressive in seeking to rescind D&O coverage by relying on purported misrepresentations in a corporate policyholder’s policy application. Because a company’s securities filings are routinely attached and form a part of a D&O policy application, policyholders can expect insurers to scrutinize such financial statements with a fine tooth comb in an effort to escape any coverage obligations.

The potential trap for a company including voluntary climate-related disclosures in its filings is clear. If the disclosure happens to be inaccurate and results in securities litigation, the insurer may seek to use that

same inaccurate disclosure to rescind the very policy designed to protect the company against such claims. Given the lack of regulatory clarity regarding climate-related disclosures, what may or may not constitute a material misrepresentation on a policy application could create a fertile ground for future coverage disputes.

Even if a company’s D&O insurer is unsuccessful in rescinding a policy because of some climate-related disclosure issue, corporate policyholders can expect their insurers to engage in “creative” arguments to avoid covering climate-related securities litigation. For example, many D&O policies contain boilerplate pollution exclusions, designed to have the policy not respond to a direct pollution event. Insurers have aggressively developed a whole body of court rulings subjecting the term “pollution” to remarkably twisted definitions.

For a policyholder who thinks the term “pollution” is subject to a common sense reading of the word, two recent Florida cases may come as a shock. In *Certain Underwriters at Lloyd’s London v. Jindoui*, a Florida court found that a pollution exclusion barred coverage for bodily injury relating to the consumption of Slush Puppies, allegedly contaminated with gasoline. Another Florida court recently found that a claim for exposure to allegedly dirty swimming pool water was not covered due to a pollution exclusion. It is remarkable that folks survive summer fun surrounded by such dangerous “pollution” as frozen drinks and swimming pools!

Given the insurance industry’s penchant to claim most anything is pollution-related, and the U.S. Supreme Court’s ruling in *Massachusetts v. EPA* that greenhouse gases constitute pollutants under the Clean Air Act, insurers may well seek to extend the reach of a pollution exclusion in a D&O policy to escape coverage for a securities lawsuit relating to climate disclosures.

Corporate policyholders should review the terms of their D&O policies in light of whatever climate-related disclosures they may be making and decide whether policy language adjustments might be warranted to address this exposure. This analysis will become even more critical as the SEC heads towards mandating climate-related disclosures. Such required disclosures, coupled with a predatory plaintiffs’ bar and a reluctant insurer partner, run the risk of creating a perfect storm for unwary companies and their directors and officers. **H**

Chinese Drywall Liability¹

By John S. Wyckoff and Robert Martin²

Abstract - This article presents an overview of the defective Chinese drywall product liability including a timeline starting when complaints were received by the Florida Department of Health in June 2008. Our overview of this rapidly evolving product liability discusses the factors that contributed to drywall demand and the production of synthetic gypsum as well as common allegations that have been made against various drywall defendants and the actions and information provided by the Consumer Product Safety Commission—the federal agency tasked with leading the investigation into drywall complaints, potential health risks, and electrical and fire safety issues. Lastly, we summarize available corporate disclosures for drywall liabilities. The drywall problem has spurred much activity from homeowners, builders, contractors, suppliers and drywall manufacturers. Much investigation has been done and more is in process, and initial findings and results are just being made available. That said, it is too early to tell the magnitude of the liability in which many facts remain unknown, and it is uncertain when the drywall problem will abate.

TIMELINE

A Chinese proverb says, “A bit of fragrance clings to the hand that gives flowers;” but for those involved with Chinese drywall, what maybe “clinging” are not-so-pleasant homeowner complaints regarding rotten-egg odors, air conditioner and other appliance failures as well as other public health and safety concerns, private and governmental investigations, and lawsuits.

The product liability issues involving Chinese drywall imported into the U.S. and installed in homes have evolved rapidly in little over one year from: initial reports of rotten-egg odors, respiratory ailments, and HVAC, appliances, electrical component failures reported in Florida homes in June 2008; to the establishment of the multi-district litigation docket 2047³; to today, with the U.S. Consumer Product Safety Commission (“CPSC”) leading the “Federal Drywall Team” that includes U.S. Environmental Protection Agency (“USEPA”) and Centers for Disease Control and Prevention (“CDC”) with ongoing investigations in collaboration with state and foreign agencies. These investigations continue along with the filing of lawsuits naming all companies in the

supply chain including both Chinese and domestic manufacturers of drywall, importers, building suppliers, drywall distributors, drywall installers, construction contractors, and home builders. **Table 1** on the following page provides a timeline of Chinese drywall-related events (see page 4).

Below we discuss factors that apparently led to the increased use of Chinese-made drywall including the mid-2000 building boom, and the 2004–2005 hurricane and storm-related damage and reconstruction. We also discuss the coincident increase in synthetic gypsum production from 2001 through 2006. We describe some of the common allegations raised in select complaints in the current drywall litigation. We discuss Knaf Plasterboard Tianjin air sample testing and compare the reported sulfide concentrations to minimum risk levels and occupational risk levels. We report on the results of investigations and activities conducted by the CPSC and the Federal Drywall Team and conclude with a summary of information and disclosures provided by certain companies regarding the defective drywall.

BUILDING BOOM, STORM ACTIVITY AND SYNTHETIC GYPSUM PRODUCTION AND USE

Many have attributed the use of Chinese drywall to stem from two factors: 1) the U.S. residential building boom between 2001 and 2006; and 2) devastating Atlantic hurricane seasons in 2004 and 2005 that resulted in unusually high hurricane and tropical storm activity with landfalls stretching from the Mid-Atlantic States to Texas.⁴ These two factors reportedly caused the need for imported Chinese drywall to satisfy an increase in demand predominantly seen in the Southeast and Gulf Coast regions. **Figure 1** (see page 5) overlays housing permits in Florida, Louisiana, and Virginia⁵ and hurricane storm damage.

Coincident with the increase in residential building and storm damage is the increased production and use of “synthetic gypsum” in drywall during the early 2000s. Gypsum (Calcium Sulfate Dihydrate), the main component of drywall, can be mined from naturally occurring deposits or can be made “synthetically” in a process utilizing flue gas desulfurization of emis-



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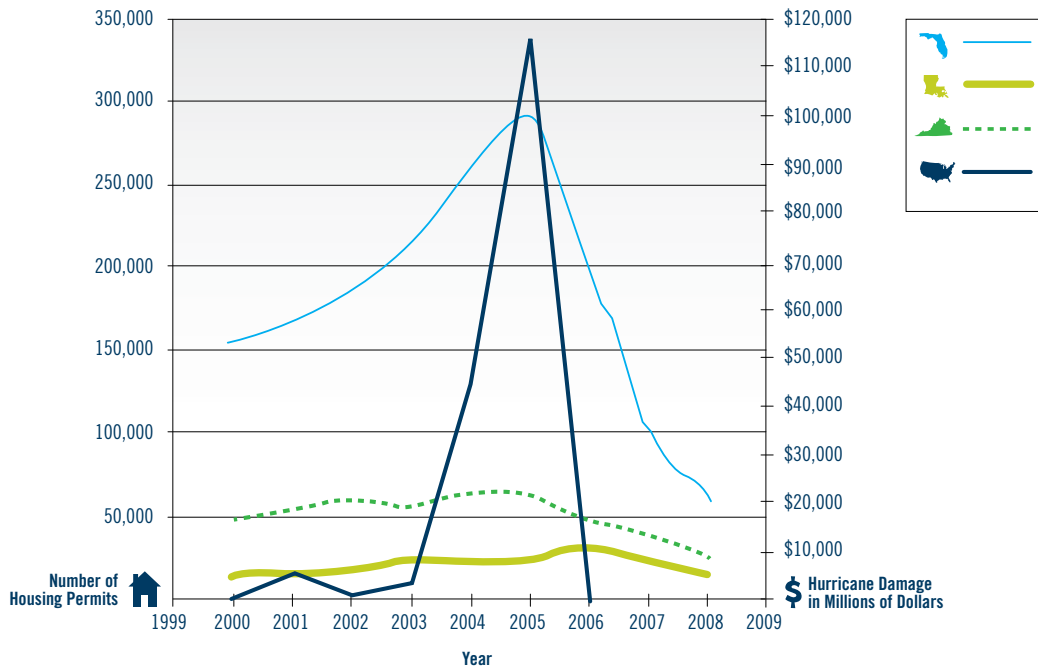
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TABLE 1 | Chronological Summary of Select Chinese Drywall-Related Events

DATE	EVENT DESCRIPTION
June 2008	Florida Department of Health (FLDOH) receives first call re sulfur odors and carbon disulfide related to drywall.
September 2008	Environ, an environmental consulting firm working on behalf of Lennar, offers to share findings with FLDOH.
January 30, 2009	Lennar Corp files lawsuit against Knauf Plasterboard Tianjin Co, USG Corp. and 12 drywall installers (see <i>Lennar Homes LLC v. Knauf GIPS KG</i> , Fla. Cir. Ct., No. 09-07901-CA-23).
January 30, 2009	Florida homeowners Shane and Nicole Allen, on behalf of themselves and a class of Florida home owners, file suit against drywall manufacturers, homebuilders, and building supply companies (see <i>Allen v. Knauf Plasterboard Tianjin</i> M.D. Fla., No. 09-CV-54-FtM-99).
March 2009	FLDOH receives Environ memo re detection of elemental sulfur at concentrations in Chinese drywall 20 times higher than those in domestically produced drywall.
March 30, 2009	<i>Keith A. Baker and Linda R. Leri v. American Home Assurance Company, Inc.</i> complaint filed. Complaint seeks coverage for damages due to drywall emitting gases and states that Rimkus Consulting Group Inc. on behalf of AIG inspected the property and conducted various tests, but that Rimkus did not share results.
April 2, 2009	Drywall Safety Act of 2009 introduced for the purpose of requiring CPSC to study drywall imported from China beginning in 2004 through 2007. The Act also calls for CPSC to determine if drywall composition regulations are necessary to protect health and safety of residential homeowners and to implement interim ban on drywall exceeding 5% organic compounds.
April 15, 2009	FLDOH publishes results of its radiological analyses of drywall samples and found alpha, beta and gamma emissions were within normal background levels.
April 23, 2009	Builders Mutual Insurance Co. sues Dragas Management, Firemen's Insurance Company, and The Hanover Insurance Company claiming coverage for drywall liabilities is barred by policy's exclusions including the pollution exclusion and "Your Work" exclusion.
April 27, 2009	<i>Michael Swidler and Jill Swidler v. Georgia-Pacific Gypsum, LLC and 84 Lumber Company LP</i> filed complaint. Complaint alleges that synthetic gypsum has infiltrated American-based manufacturers and is not solely limited to Chinese companies.
May 6, 2009	After receiving its first drywall-related complaint on February 20, the Louisiana Department of Health and Hospitals published its survey of 202 homes. Of the respondents, 52% of the homes had odors, 44.6% had A/C evaporator coil failure, and 41.1% had confirmed Chinese drywall. Health effects were also surveyed and the most common symptoms (top six) reported included headache, dry cough, eye irritation, irritated throat, respiratory infection, and nosebleeds.
May 7, 2009	USEPA publishes the results of its sampling and analysis of 6 drywall samples (two from Florida homes and known to be manufactured in China, and four purchased from local stores in Edison, NJ, known to be domestically manufactured). Sulfur was detected at 83 parts per millions (ppm) and 119 ppm in the Chinese drywall samples. Sulfur was not detected in the four US-manufactured drywall samples. Strontium was detected at 2,570 ppm and 2,670 ppm in the Chinese drywall samples. Strontium was detected in the US-manufactured drywall at 244 ppm to 1,130 ppm.
June 3, 2009	ATSDR publishes its "Imported Drywall and Health – A Guide for Health Care Providers."
June 15, 2009	MDL 2047 Transfer Order consolidating a total of 10 cases involving eight cases from Florida, one from Louisiana, and one from Ohio.
July 2009	CPSC publishes July 2009 Status Report describing its efforts including testing and investigation of drywall.
August 6, 2009	<i>Wall Street Journal</i> reported that Phillip Goad, principal toxicologist and partner at the Center for Toxicology and Environmental Health ("CTEH") in North Little Rock, Arkansas was hired by Knauf Tianjin and that Dr. Goad reported that the levels of disulfide and carbonyl sulfide emitted by some of company's drywall would not damage health. The article also reported that Donald Hayden, an attorney for Knauf Tianjin, stated that the company accounted for 20% of the Chinese-made drywall imported into the US from 2004 through 2007.
August 19, 2009	CPSC publishes press release regarding testing for phosphogypsum and potential radioactivity. Testing showed no radioactivity contrary reported allegations.
August 2009	CPSC publishes August 2009 Status Update. Provides summary and progress of investigations and analyses outlined in its July 2009 status report.
September 2009	CPSC publishes September 2009 Status Update. Updates include China visit, and drywall elemental and emission analyses.

FIGURE 1 | Graph Showing Housing Permits (FL, LA & VA) and Hurricane Damage (in Millions of Dollars) in US



sions from coal-fired power plants. The USGS reported in 2000 that “[s]everal large [U.S.] wallboard plants under construction and designed to use only synthetic gypsum will accelerate substitution [of mined gypsum] significantly as they become operational within the next 2 years [2001 and 2002]”⁶ The USGS Annual Mineral Commodity Summaries for gypsum indicates a significant increase in synthetic gypsum from 2000 (4,950 million tons) to 2002 (9,900 million tons).

While much of the attention has focused on Chinese drywall as described below in section III Common Allegations, a domestic drywall manufacturer also has been sued for allegedly producing defective drywall made with synthetic gypsum. More specifically, in *Michael Swidler et al. v. Georgia-Pacific*, the complaint raised the allegation that U.S. drywall made with synthetic gypsum⁷ is also defective.

COMMON ALLEGATIONS CONCERNING DEFECTIVE DRYWALL

We reviewed several complaints filed by homeowners and home builders and have summarized some of the common allegations from a few of the complaints that follow.

A. *Shane M. Allen, et al. v. Knauf Plasterboard Tianjin,*

et al.

In *Shane M. Allen, et al. v. Knauf Plasterboard Tianjin et al.* (Case No. 2:09-CV-54-FtM-99 DNF, U.S. Dist. Ct. Mid Dist. of Florida, Fort Myers Div., filed January 30, 2009), the complaint alleges that, “Defendants negligently manufactured, processed, distributed, delivered, supplied, inspected and/or sold defective drywall, which was unreasonably dangerous in its normal use in that the drywall caused corrosion to air-conditioning and refrigerator units, electrical wires, and copper tubes, and caused allergic reactions, coughing, sinus and throat infection, eye irritation, breathing hazards, and other health concerns (paragraph 12).” The complaint states that the, “Defendants’ drywall was made with waste material from scrubbers on coal fired power plants, also called ‘fly ash.’⁸ These materials can leak into the air and emit one of several sulfur compounds including sulfur dioxide and hydrogen sulfide (paragraph 13).

B. *Lennar Homes, LLC v. Knauf Gips KG, et al*

In *Lennar Homes LLC v. Knauf Gips KG, et al.* (Case No. 09-07901CA23, 11th Judicial Circ. Miami Dade Co. Florida, filed January 30, 2009), *Lennar* states that *Knauf Gips* introduced advanced production technology

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into China and from 1997 through 2001 and established three plasterboard plants located in Wuhu, Tianjin, and Dongguan (Paragraph 6). The complaint states that,

“The unreasonably defective drywall...appears to be interacting with other conditions and elements, causing damage to other property...including but not limited to HVAC coils, certain electrical and plumbing components and other affected materials and items (“the Other Property”). This corrosion and damage is observable as a black surface accumulation on the Other Property” (paragraph 42).

Unlike *Allen*, however, *Lennar* does not allege that the defective drywall is made with coal fly ash. *Lennar* also states that testing conducted by its environmental consultant Environ confirmed that there is no indication that the conditions in affected homes would pose any adverse human health effects.

C. *Michael Swidler, et al. v. Georgia-Pacific Gypsum, et al.*

In *Michael Swidler, et al v. Georgia-Pacific Gypsum, et al.* (Case No. 5:09-cv-00181-WTH-GRJ, U.S. Dist Ct. Middle Dist. Florida, Ocala Div., filed April 27, 2009), plaintiffs allege that drywall manufactured by *Georgia-Pacific* (the first domestic drywall producer to be named in a lawsuit re defective drywall) “is causing sulfur compounds and damages in much the same manner as the Chinese drywall...(paragraph 2)” The complaint states that, “...recent advancements in technology have created a new form of gypsum known as ‘synthetic gypsum’ which is a by product produced by coal burning power plants...” and further emphasizes that “synthetic gypsum is at the heart of the present drywall crisis (paragraph 16). The plaintiffs allege that *Georgia-Pacific*’s “ToughRock” contains excessive amounts of sulfur-based pollutants due to its high content of synthetic gypsum. When the ToughRock’s temperature becomes elevated sulfur-based gases are released which cause damage to the metal components of products (paragraph 23).

D. Other Defective Drywall Allegations

In addition to the above, another allegation reported in the *Los Angeles Times* (July 4, 2009) concerned the possible use of phosphogypsum in drywall imported from China. EPA has regulated phosphogypsum since 1989 and has banned all use of the material, except for phosphogypsum with extremely low radionuclide

concentrations. In response to phosphogypsum concerns, the Consumer Product Safety Commission along with the Florida Department of Health collected 21 samples of drywall from homes that exhibited odors, corrosion, and occupant complaints and found the radiation levels between domestic and imported drywall were no different and were comparable to background levels and did not pose a health risk. (See August 10, 2009 Report <http://www.cpsc.gov/info/drywall/tefinal.pdf>).

CONSUMER PRODUCT SAFETY COMMISSION—ITS ACTIVITIES AND FINDINGS

The Consumer Product Safety Commission (“CPSC”) is the lead U.S. government agency investigating defective drywall and is being supported by the U.S. Environmental Protection Agency (“EPA”), Agency for Toxic Substances and Disease Registry (“ATSDR”) and Centers for Disease Control and Prevention (“CDC”). Together, this multi-agency effort, aka the “Federal Drywall Team,” is investigating the importation of Chinese drywall, affected homes, and assessing health and safety risks including potential for fire hazards that may arise from corroded electrical components. CPSC is also coordinating with the EPA Emergency Response Team and State Emergency Response members including state departments of health.

CPSC July 2009 Status Report

In July 2009, the CPSC reported: 1) CPSC and CDC are developing an air sampling protocol (published August 2009), the existence and results of 2009 “odor” study of Chinese drywall and gypsum rock samples from a Chinese mine (LuNeng) in ShanDong province⁹; 2) CPSC is working with the Chinese Government and looking at additives in the drywall; 3) CPSC is exploring the drywall chain of commerce and has reported difficulty in tracking imports due to the use of a single commodity code for ceiling/acoustic tile and drywall; 4) over 5.5 million sheets of drywall were imported into U.S. in 2006; 5) CPSC is conducting 50 in-depth investigations (“IDI”) of drywall complaints from homeowners; 6) CPSC/CDC is conducting health effects analysis including: a) elemental analysis (due to be completed in August); b) chamber studies to assess the emissions from drywall -- in two investigation phases with results due in late August and September 2009 respectively; and c) in-home indoor air

sampling (draft report due mid September; 8) CPSC will be conducting an engineering analysis to assess effects of drywall emissions on electric, gas, HVAC and fire safety equipment (various switches, receptacles, circuits, flex gas connectors/gas distribution pipe, sprinklers and smoke detectors) for possible fire and shock hazards and impact on other in-home items including picture frames, light fixtures, and mirrors. Sampling is due to be completed in September; no date is provided for when this report would be completed or released.

CPSC August 2009 Status Report

In its August status report, the CPSC reported: 1) that 810 drywall-related complaints were received from 23 states including reports from two new states (Pennsylvania and South Carolina) and that the majority of the reports were from Florida, Louisiana, and Virginia; 2) the Federal Drywall Team has conducted numerous activities including chamber testing of drywall samples to isolate specific emissions, sampling indoor air of 50 homes, visiting a Florida synthetic drywall manufacturing facility, and posting 44 incident investigation summaries on CPSC's *Drywall Information Center* Web site and testing drywall for presence of radioactive phosphogypsum contamination; 3) CPSC has approval to conduct an investigation in China beginning August 17; 4) CPSC confirmed 6,211,200 sheets of Chinese drywall were imported into the U.S. plus 28,778 sheets were imported in Guam, Saipan, and American Samoa during 2006; 5) CPSC continues investigating electrical equipment and appliance damage and confirmed no fire incidents involving electric component corrosion and Chinese drywall have been identified; 6) CPSC/USEPA anticipate completing elemental analyses of drywall samples collected in July and report the results by the end of September; 7) allegations of the use of radioactive phosphogypsum in some imported drywall were investigated by the CPSC and it published its results on August 10th that radiation levels were comparable to background levels and posed no radiation safety risks.

CPSC September 2009 Status Report

In September 2009, the CPSC reported: 1) 382 additional incidents were received since the August report, raising the total incident reports to 1,192 including incidents from one new state, South Carolina, bringing total number of states to 24; 2) completion of

principal field work for 50 home indoor air sampling program; 3) completion of 75 IDIs with another 20 in progress; 4) CPSC staff met with Chinese government officials and inspected gypsum mines and drywall manufacturing plants and collected raw materials and finished products for further testing; 5) confirmed nearly seven million sheets of drywall were imported in 2006; 6) EPA is conducting elemental analysis of 15 drywall samples and expects to complete this analysis in September and report findings to the CPSC in October; 6) chamber studies remain in progress and that additional samples from CPSC's China visit will be added to the study.

KNAUF INVESTIGATION

In response to concerns from its customers regarding the sulfur-like smell of its drywall, Chinese drywall manufacturer Knauf Plasterboard Tianjin ("KPT"), commissioned a study performed by Center for Toxicology and Environmental Health ("CTEH"). In this study, CTEH analyzed air quality in five homes, one of which did not contain KPT drywall, in the Miami-Fort Lauderdale, Florida area. CTEH also performed chemical analysis of bulk plasterboard from KPT, another Chinese manufacturer, and a domestic manufacturer. A summary of the results of this study entitled "Summary of Air Sampling Results, November 29, 2006," reports that carbonyl sulfide (which has a foul odor) and carbon disulfide (which has an ether-like odor) were detected in all samples associated with KPT product. CTEH concluded that sulfur-based compounds can be emitted from Knauf Tianjin drywall but that "the measured concentrations in homes containing Knauf Tianjin product are not at levels that should be considered a public health concern." CTEH also reports that, "[c]hemical analysis of the bulk plasterboard indicates that it contains a naturally-occurring iron disulfide (e.g., pyrite)." Both KPT drywall and drywall from the other Chinese manufacturer tested contained pyrite and had an odor similar to each other. CTEH's analysis suggests pyrite may be the source of the sulfur-containing compounds that are emitted from the drywall.

TOXICOLOGY

ATSDR Healthcare Provider Guide

The ATSDR issued a fact sheet, "Imported Drywall and Health – A Guide for Healthcare Providers," in

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June 2009 in response to numerous reports received by the CPSC from residents who believed their health symptoms or corroded metal components in their homes were related to Chinese drywall. The ATSDR stated that “not enough information exists to determine the nature and magnitude of a potential health risk.” The fact sheet addresses two sulfur-based chemicals, carbonyl sulfide and carbon disulfide, that were detected in limited testing performed by a consultant for a drywall manufacturer. Short term exposure (hours) to low concentrations of these chemicals can lead to the following health symptoms: eye irritation, sore throat, stuffy nose, nausea, headaches and shortness of breath. For chronic exposure (days to weeks), symptoms include fatigue, loss of appetite, poor memory, irritability, and dizziness. People most at risk according the ATSDR are people with asthma or chronic obstructive pulmonary disease (COPD), the elderly and young children with compromised respiratory function.

Sulfides: Carbonyl Sulfide, Carbon Disulfide, and Hydrogen Sulfide

Carbonyl Sulfide, Carbon Disulfide, and Hydrogen Sulfide¹⁰ were reported in CTEH’s November 2006 summary. We reviewed occupational safety and health standards for these chemicals and summarize key guidelines such as ATSDR minimum risk levels (“MRL”) and Occupational Safety and Health Administration (“OSHA”) permissible exposure limits (“PEL”) versus concentration levels reported in CTEH’s November 2006 summary of air

sampling of homes and drywall products. MRLs are ATSDR reported exposure levels that, based on current information, are below levels that might cause adverse health effects to people most sensitive to the substance. MRLs are used as screening levels by ATSDR health assessors and other responders. PELs, on the other hand, are enforceable, regulatory limits set by OSHA to protect workers from adverse health effects of occupational exposure to hazardous substances. **Table 2** below summarizes MRLs and PELs versus concentrations reported by CTEH.

COMPANY FINANCIAL DISCLOSURES REGARDING DEFECTIVE DRYWALL

We conducted a search of certain companies named as defendants in the complaints including suppliers, home builders, and developers in an effort to summarize their disclosures regarding defective drywall. The private companies are not required to provide financial disclosures and the companies that have entered bankruptcy do not provide annual or quarterly reports with disclosures. Those that reported indicated that they discovered the drywall issue sometime between January and March 2009 after receiving complaints regarding odors, electrical equipment failure, and corrosion.

Only one company has recorded a receivable for insurance and those that did not report stated it was too early to record a receivable for potential recoveries. Based on the disclosures, companies estimate that it will cost approximately \$100,000 per affected home. This

TABLE 2 | **Summary of Risk Levels and Exposure Limits v. CTEH Reported Concentrations**

SUBSTANCE	ODOR THRESHOLD	ATSDR MRL	OSHA PEL	CTEH REPORTED CONCENTRATIONS
Carbonyl Sulfide	Not reported	None	None	16 ppb maximum
Carbon Disulfide	20 ppb	Chronic (Inhalation, >364 days) 300 ppb	20 ppm over 8 hours; 100 ppm 30 minute peak	14 ppb maximum
Hydrogen Sulfide	0.5 ppb	Intermediate (Inhalation, 15 to 364 days) 20 ppb; Acute (Inhalation, 1–14 days) 70 ppb	20 ppm over 8 hours; 50 ppm over 10 minutes (one time only)	2.3 to 4.1 ppb Highest concentration of 4.1 ppb taken from air inside packing of unused drywall

amount was also reported by the National Association of Home Builders. In summary, we identified disclosures regarding defective drywall for Beazer Homes, D.R. Horton, Inc., Lennar Corp, and The Ryland Group, Inc. We did not find disclosures for Hovnanian Enterprises, Inc.,¹¹ Pulte Homes/Centex or K. B. Home and did not find disclosures by Chinese or U.S. manufacturers or drywall distributors.

Beazer Homes reported that it accrued \$2.4 million in warranty reserves for the repair of approximately 30 homes in southwest Florida that were delivered during 2006 and 2007. The company reported that it is inspecting additional homes for defective Chinese drywall to determine if an increase in warranty reserves is required in the future (see 10-Q filed August 7, 2009). D.R. Horton, Inc. recorded charges of \$4 and \$6 million for repair of approximately 75 homes in South Florida and Louisiana respectively. The company reported that these homes were constructed during 2005 and 2007 (10-Q filed August 5, 2009).

Lennar in its July 2009 10-Q filing reported that as of May 31, it identified 400 homes with defective Chinese drywall, has accrued \$39.8 million of warranty reserves, and has a \$20.7 million receivable for covered damages under its insurance coverage. Additionally, the company is seeking reimbursement from subcontractors, insurers and others for costs associated with investigating and repairing defective Chinese drywall and resulting damage. Lennar also stated that as of July 10, 2009, 41 Florida state lawsuits and two federal class action lawsuits have been filed against it; meanwhile, the Company has sued the entire supply chain including Chinese and German drywall manufacturers.

The Ryland Group Inc. reported that as of June 30, 2009, (see 10-Q filed on August 4, 2009) the Company identified approximately 50 to 60 homes delivered in three communities that are confirmed to have damage resulting from defective drywall. Ryland estimated costs to repair these homes at \$4.5 million to \$6.0 million. The company reported it has not identified any defective drywall from China used in homes outside of these communities. The company is continuing investigation of its homes.

According to the *Wall Street Journal* (September 2, 2009), WCI Communities, a developer emerging from bankruptcy, reported that the Company: a) has more than 160 cases; b) will contribute \$900,000 to

administer a fund; and c) its claims could run as high as \$97.3 million.

CONCLUSION

As stated at the outset, the Chinese drywall problem has evolved rapidly. It is likely that significant information will be generated from CPSC's health assessments, indoor air quality testing, and investigations of Chinese drywall manufacturing plants to be published in the fourth quarter of 2009. Coincidentally, we anticipate that significant data and information will be generated as a result of fact-finding efforts pursuant to pretrial orders¹² issued in the Chinese-Manufactured Drywall Products Liability MDL. During the course of these and other efforts, it is more likely than not, that new allegations will be made and prior allegations will be disproved.

A significant allegation that remains to be fully investigated involves domestically produced drywall made with synthetic gypsum giving rise to similar problems as those associated with Chinese drywall. This allegation may significantly expand the universe of affected homes. It remains unclear if the Chinese produced synthetic gypsum is different from U.S.-produced synthetic gypsum. Similarly, the resolution involving the defective drywall will depend on ease of which the problems associated with the defective drywall can be remediated. Given the above, it is too early to tell if the early remedial efforts involving defective drywall removal are effective and when this rapidly emerging liability will abate. **H**

Sources of Information

- ▶ Consumer Product Safety Commission Drywall Web page: (see <http://www.cpsc.gov/info/drywall/index.html>).
- ▶ Florida Department of Health Drywall Web page (see <http://www.doh.state.fl.us/Environment/community/indoor-air/drywall.html>)
- ▶ U.S. District Court for the Eastern District of Louisiana MDL-2407 Chinese-Manufactured Drywall Products Liability Litigation Web page (<http://www.laed.uscourts.gov/Drywall/Drywall.htm>) This Web site provides information regarding issued orders and entries, court calendar, reports, contacts, transcripts and frequently asked questions. The Web pages for calendar, reports and transcripts remain "under construction."
- ▶ Agency for Toxic Substances & Disease Registry (ATSDR) Web page - ATSDR's Response to Imported Drywall (<http://www.atsdr.cdc.gov/drywall/>).

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- ▶ Centers for Disease Control and Prevention Web page – CDC’s Response to Imported Drywall (<http://www.cdc.gov/nceh/drywall/>). This Web page contains the same information as ATSDR’s.
- ▶ Wotapk, Dawn, September 2, 2009, “Drywall Clouds on Hovnanian Horizon,” in Wall Street Journal.
- ▶ Agency for Toxic Substances and Disease Registry. *Medical Management Hydrogen Sulfide*. <http://www.atsdr.cdc.gov/mhmi/mmg114.html> (accessed 18 September 2009).
- ▶ Agency for Toxic Substances and Disease Registry. *Medical Management Carbon Disulfide*. <http://www.atsdr.cdc.gov/mhmi/mmg82.html> (accessed 18 September 2009).
- ▶ Agency for Toxic Substances and Disease Registry. Minimum Risk Levels. December 2008. http://www.atsdr.cdc.gov/mrls/pdfs/atsdr_mrls_december_2008.pdf (accessed 18 September 2009).
- ▶ Occupational Safety and Health Administration. Health guideline for carbon disulfide. <http://www.osha.gov/SLTC/healthguidelines/carbondisulfide/index.html> (accessed 18 September 2009).
- ▶ Occupational Safety and Health Administration. Code of Federal Regulation (CFR) Part 1926–safety and health regulations for construction. Table Z-2. http://www.osha.gov/pls/oshaweb/owadis.show_document?p_table=STANDARDS&p_id=9993 (accessed 18 September 2009).

ENDNOTES

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- ³ MDL No. 2047 U.S. Dist. Ct. East. Dist. of Louisiana in June 2009. Currently – as of September 1, 2009 the Defective Drywall MDL has over 150 lawsuits. September 1, 2009, personal communication between Dean Oser, Docket Clerk, U.S. Dist Ct. East Dis. of Louisiana and John Wyckoff, Vice President CapAnalysis, LLC.
- ⁴ NOAA in its Annual Summary Atlantic Hurricane Season of 2004 stated that Florida, the “Sunshine State,” became know as the Plywood State after being battered by Charley, Frances, Ivan, and Jeanne. In addition, the following year, 2005, proved to be a year with most damage as a result of the following named hurricanes Cindy, Dennis, Katrina, Ophelia, Rita, and Wilma having made landfall in the U.S. NOAA has not published its annual summaries or estimates of storm damage for 2007 and 2008.
- ⁵ These three states were chosen because they have been the source of most of the incident reports related to Chinese drywall received by Consumer Products Safety Commission.
- ⁶ USGS 2000 Mineral and Commodity Summary for gypsum. <http://minerals.usgs.gov/minerals/pubs/commodity/gypsum/320301.pdf>. The USGS commodity summaries for gypsum do not report imports of synthetic gypsum only imports of mined gypsum. Therefore we are not able to compare imports of synthetic or imported wall board using synthetic gypsum with domestic production of synthetic gypsum and wall board containing synthetic gypsum.
- ⁷ We note that the U.S. EPA drywall sample analysis for the ATSDR in May 2009 reported no sulfur was detected in Georgia-Pacific’s synthetic gypsum drywall, ToughRock.
- ⁸ We also note that the U.S. EPA reported no evidence of fly ash in Chinese drywall samples based on optical microscopic examination in its May 2009 analysis for the ATSDR.
- ⁹ The study entitled “Identification of Odor-Active Organic Sulfur Compounds in Gypsum Products,” and authored by Freitag et al appeared in 2009 [February] Clean Journal. The samples analyzed involved Chinese gypsum board, gypsum powder, and two samples of “natural raw stone” [gypsum]. It is unclear if the gypsum board was produced from mined gypsum or synthetic gypsum.
- ¹⁰ Hydrogen sulfide (which considered highly toxic) was also detected in air sampling by CTEH but at low levels (not requiring concern) ranging from 2.3 to 4.1 parts per billion (ppb) compared to level of 3.2 ppb for an outdoor air sample.
- ¹¹ In September 2, 2009, “Drywall Clouds on Hovnanian Horizon,” the *Wall Street Journal* reported that investors were interested in Hovnanian Enterprises drywall disclosures (if any) to be reported in its third quarter report to be filed on September 4. A review of the Hovnanian’s third quarter 10-Q indicates that the Company did not report or disclose issues related to the Chinese drywall.
- ¹² The Pretrial Orders (PTO) include PTO No. 11 re Plaintiff and Defendant Profile Form; PTO No. 12 Distributor Profile form, PTO No. Threshold Inspection Program

Case Highlights

By Seth Lamden

SOUTH CAROLINA

CGL policy provides coverage for trademark infringement claim

***Super Duper Inc. v. Pennsylvania Nat'l. Mut. Ins. Co.*, No. 26717, 2009 WL 2948516 (S.C. Sept. 14, 2009)-South Carolina**

Among the liabilities for which standard commercial general liability (“CGL”) policies provide coverage are claims seeking damages for “advertising injury.” While the specific wording of the CGL policy definition of “advertising injury” may vary from policy to policy, “advertising injury” often is defined to include “injury arising out of one or more of the following offenses: . . . Misappropriation of advertising ideas or style of doing business; or Infringement of copyright, title or slogan.” *Id.* at *3. At issue in *Super Duper Inc. v. Pennsylvania Nat'l. Mut. Ins. Co.*, No. 26717, 2009 WL 2948516 (S.C. Sept. 14, 2009), was whether trademark infringement constitutes a covered “advertising injury” offense under various similarly-worded CGL policies. The *Super Duper Inc.* court found that “advertising injury” does include trademark infringement and, as such, a claim for trademark infringement was covered under a number of similar CGL policies.

The coverage dispute in *Super Duper, Inc.* arose when Mattel, Inc. (“Mattel”), a toy manufacturer, challenged Super Duper, Inc.’s (“SDI”) registration of four trademarks and filed formal notices of opposition and petitions for cancellation with the United States Patent and Trademark Office. *Id.* at *1. Following Mattel’s challenge to the trademarks, SDI sued Mattel in federal district court, seeking a declaration that its trademarks did not infringe upon Mattel’s trademarks. *Id.* Mattel brought a counterclaim against SDI, asserting trademark infringement. *Id.*

SDI provided timely notice of the Mattel counterclaim to its CGL insurers and requested a defense, claiming that the Mattel trademark infringement claim was a claim for covered “advertising injury.” Several of SDI’s CGL policies defined “advertising injury” to mean “injury arising out of one or more of the following offenses: . . . [m]isappropriation of advertising ideas or style of doing business; or [i]nfringement of copyright, title or slogan.” *Id.*

The SDI court held that the underlying Mattel trademark infringement counterclaim could qualify as a suit seeking damages for “advertising injury” pursuant to the preceding definition because trademark infringement constitutes “misappropriation of advertising ideas or style of doing business.” *Id.* at *3. In so ruling, the SDI found that because the undefined term “misappropriation” must be interpreted broadly and in favor of coverage under the rules of insurance policy interpretation, “misappropriation” means simply “to appropriate dishonestly for one’s own use . . . [or] to appropriate wrongly or misapply in use.” *Id.* at *3. Applying the same broad rules of policy construction, the SDI court also found that a trademark can constitute an “advertising idea or a style of doing business” because a trademark “serves as a prime instrument in the advertisement and sale of the seller’s goods.” *Id.* at *4. As such, reasoned the SDI court, “misappropriation of advertising ideas or style of doing business” encompasses “any claim related to the wrongful use of a trademark” and, therefore, a claim for trademark infringement can be for covered “advertising injury.” *Id.*

As an alternate basis for finding that trademark infringement falls within the advertising injury provisions of a CGL policy, the SDI court held that trademark infringement could constitute “infringement of copyright, title or slogan.” *Id.* at *4. The SDI court relied on the dictionary definitions of the terms “title” (“a descriptive name”) and “slogan” (“a brief striking phrase used in advertising or promotion”) to find that “trademarks, titles and slogans are heavily related and can be synonymous. Thus, coverage for ‘infringement of copyright, title or slogan’ may envelop trademark infringement.” *Id.* at *5.

Some of SDI’s CGL policies contained slightly different definitions and defined “advertising injury” to include “injury arising out of the offense of ‘infringing [upon] another’s copyright, trade dress, or slogan in your advertisement.’” *Id.* at *6. Having already found that the term “slogan” may encompass trademarks, the SDI court considered whether “trade dress” also may encompass a trademark. The SDI court concluded that it does because “trade dress refers to the product’s packaging, the product’s shape and design, and the



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totality of elements creating the product's overall image Therefore, a trademark may serve as an element to the overall trade dress of a product." *Id.*

Upon issuing the *Super Duper, Inc.* decision, the Supreme Court of South Carolina joined a growing body of courts that have held that claims for trademark infringement can be covered under the "advertising injury" coverage provided by most CGL policies. While some CGL insurers have begun endorsing their CGL policies to exclude claims for trademark infringement, the majority of previously-issued CGL policies do not exclude coverage for trademark infringement claims.

TEXAS

Commercial general liability ("CGL") policies provide coverage for damages for property damage caused by an "occurrence" (an accident or exposure to harmful conditions).

***Century Surety Co. v. Hardscape Construction Specialties, Inc.*, No. 06-10930, 2009 WL 2413935 (5th Cir. Aug. 7, 2009)-Texas**

Commercial general liability ("CGL") policies provide coverage for damages for property damage caused by an "occurrence" (an accident or exposure to harmful conditions). For more than two decades, insurers have argued, with varying degrees of success, that claims for property damage arising from poor workmanship, faulty construction and design flaws are not covered under CGL policies because in such cases, the insured's liability arises from a breach of its contract with the plaintiff and a breach of contract cannot constitute an "occurrence." This argument ignores the fact that parties may perform their contractual obligations negligently, causing property damage. In addition to finding that a defective construction claim can involve a covered occurrence, the court in *Century Surety Co. v. Hardscape Construction Specialties Inc.*, No. 06-10930, 2009 WL 2413935 (5th Cir. Aug. 7, 2009), considered a related issue of whether a demand for indemnity brought by a general contractor against its subcontractor was barred by an exclusion in the subcontractor's CGL policy for liability assumed under contract when the claim against the general contractor alleged both breach of contract and negligence claims.

The underlying dispute in *Century Surety Co.* arose when Hardscape Construction Specialties, Inc. ("Hardscape") contracted with Hillwood Residential Services, L.P. ("Hillwood") to construct a swimming pool facility at a residential development. *Id.* at *1. The Hillwood-Hardscape contract obligated Hardscape to indemnify Hillwood "from and against any damage, liability or cause of action arising directly or indirectly out of or in connection with the performance of [Hardscape's] services." *Id.*

Hardscape then executed a subcontract with Elite Concepts ("Elite"), pursuant to which Elite would construct the swimming pool. *Id.* Elite agreed to indemnify Hardscape for liability arising from construction of the pool. *Id.* After the completion of the swimming facility, Hillwood sued Hardscape, alleging that faulty design and construction of the pool had caused physical and aesthetic damage to the pool after cracks appeared and water escaped from the pool. *Id.* Hillwood's complaint alleged breach of contract, negligence, breach of implied warranty and breach of express warranty. *Id.*

Pursuant to the Hardscape-Elite subcontract, Hardscape demanded that Elite defend and indemnify it in the Hillwood lawsuit. *Id.* Elite tendered Hardscape's demand to Century Surety Co., its CGL insurer. When Century failed to respond to Elite's tender, Hardscape pursued Elite's insurance claim against Century on behalf of Elite even though Hardscape was not an insured on the Century policy. *Id.* Although Elite's CGL policy excluded coverage for liability that Elite assumed pursuant to contract, the contractual liability exclusion was subject to an exception specifying that the exclusion did not bar coverage for tort liability (defined in the policy to mean "liability that would be imposed in the absence of any contract or agreement") assumed by Elite in a "contract or agreement pertaining to [Elite's] business." *Id.* at *3. The CGL policy refers to a contract or agreement to assume the tort liability of another as an "insured contract." *Id.*

Century denied coverage for the Hardscape claim for two reasons. First, Century argued that the "construction errors" alleged in the Hillwood complaint did not constitute a covered "occurrence." *Id.* at *2. The *Century Surety Co.* court rejected this argument and found that "allegations of unintended construction defects may constitute an 'accident' or 'occurrence'" under CGL



policies, even when they arise from a contractual relationship. *Id.* (following *Lamar Homes, Inc. v. Mid-Continent Casualty Co.*, 242 S.W.3d 1 (Tex. 2007)).

Century's second reason for denying coverage was that the claim against Hardscape did not fall within the scope of the "insured contract" exception in Elite's CGL policy. *Id.* at *3. Century argued that even though the Hillwood claim alleged that Hardscape was negligent, the only claim against Hillwood was for damage to the pool itself and the complaint made clear that Elite, not Hardscape, designed and constructed the pool. *Id.* at *4. Stating that "an action seeking to recover damages to the subject matter of a contract constitutes a contract claim only, not a tort claim," the *Century Surety Co.* court agreed with Century and held that the "insured contract" exception was inapplicable. *Id.* The court stated that even though Hillside alleged in its complaint that Hardscape was negligent, any liability faced by Hardscape arose solely by virtue of the Hardscape-Hillwood contract and, therefore, involved contractual liability only. As such, no tort claim triggered the "insured contract" exception to the contractual liability exclusion in Elite's CGL policy. *Id.* at *6.

It is worth noting that Hardscape, the general contractor, sought a defense and indemnity from Elite, its

subcontractor, pursuant to the indemnity provisions of the Hardscape-Elite subcontract. Because Hardscape was not an insured on the Century CGL policy, whether its claim was covered under the Century CGL policy turned on whether the claims against it were rooted in tort or contract. The tort/contract distinction would have been irrelevant had Hardscape been added as an additional insured to Elite's CGL policy. Unlike the "insured contract" exception to the contractual liability exclusion, whether an additional insured is entitled to coverage under a CGL policy does not depend on the whether the claim against the additional insured is based on tort or contract.

WASHINGTON

"Prior knowledge" exclusion in E&O policy does not bar coverage

***Westport Ins. Corp. v. The Markham Group, Inc.*, No. CV-08-221-RHW, 2009 WL 2777845 (E.D. Wash. Aug. 26, 2009)-Washington**

While the specific wording and coverage provided by Errors & Omissions ("E&O") Liability Policies varies from insurer to insurer and industry to industry, virtually

[Continued on page 14]

all E&O policies are written as “claims made” policies, which means that they only provide coverage for claims that occur while the policy is in force. When a prospective insured applies for claims-made insurance, the application generally requires disclosure of facts or circumstances that may give rise to a future claim, and claims arising from those facts or circumstances may be excluded under the terms of the new policy. Because many claims arise from acts, errors or omissions that occurred before the policy was issued, it is not uncommon for insurers to raise a “prior knowledge” policy exclusion as a coverage defense.

The touchstone in coverage disputes regarding the applicability of a “prior knowledge” exclusion often is whether the insured knew or reasonably should have known that acts, errors or omissions committed prior to the policy period could give rise to a claim against the insured. This inquiry turns on the specific facts of each case and, as illustrated in a recent decision by the United States District Court for the Eastern District of Washington, the specific language of the exclusion itself. See *Westport Ins. Corp. v. The Markham Group, Inc.*, No. CV-08-221-RHW, 2009 WL 2777845 (E.D. Wash. Aug. 26, 2009). The *Westport Ins. Corp.* court found that the following “prior knowledge” exclusion in an attorneys’ professional liability policy was ambiguous and unenforceable because the use of the term “might” did not provide the insured with adequate guidance regarding which claims were excluded:

[This policy does not apply to any claim based on] [a]ny act, error, omission, [or] circumstance . . . occurring prior to the effective date of the POLICY if any INSURED at the effective date knew or could have reasonably foreseen that such act, error, omission, [or] circumstance . . . might be the basis of the CLAIM.

Id. at *3.

In the underlying lawsuit in *Westport Insurance Corp.*, the insured attorney represented a client in a wrongful death suit against a nursing home operator arising out of the death of the client’s father. *Id.* at *4. In an August 2006 order granting summary judgment to the operator of the nursing home in the underlying case, the trial court stated that if the insured “had made a reasonable inquiry as to the actual operator of . . . [the

facility], he would have determined that the licensed operator on the date of the alleged negligent acts was not the named Defendant but another party[.]” *Id.* at *4. The court also imposed sanctions against the insured. *Id.* Two months after the adverse ruling, in October 2006, the trial court denied the insured’s motion for reconsideration and leave to file an amended complaint. *Id.* A year later, in December 2007, the Washington Court of Appeals affirmed the trial court’s ruling. *Id.* The client subsequently brought a legal malpractice claim against the insured arising out of the representation. *Id.*

When the insured attorney provided notice of the legal malpractice claim to his professional liability insurer, the insurer denied coverage pursuant to the “prior knowledge” exclusion quoted above. *Id.* at *3. The insurer argued that prior to the policy’s July 2007 inception date, the insured reasonably could have foreseen that a claim might be made against him when the trial court entered its August 2006 order granting summary judgment in favor of the defendant in the underlying suit. *Id.*

The insured argued that the policy’s “prior knowledge” exclusion was ambiguous because the use of the term “might” in relation to circumstances that “might” be the basis of a claim was vague and ambiguous and “does not clearly indicate when a claim might be excluded.” *Id.* at *4. The *Westport Insurance Corp.* court agreed with the insured, noting that any number of events in the underlying wrongful death claim – including the trial court’s order granting summary judgment in favor of the defendant and the trial court’s denial of the plaintiff’s motion for reconsideration – “might” be the basis for a claim. *Id.* at *4-5.

The *Westport Insurance Corp.* court concluded that a reasonable interpretation of the term “might” in the context of the policy’s prior knowledge exclusion was that it means “when a reasonable attorney would believe that there are no longer any meaningful avenues of relief to pursue.” *Id.* at *9. Accordingly, the court held that the prior knowledge exclusion did not bar coverage because “this occurred at the earliest” when the insured did not appeal the appellate court’s decision to the Washington Supreme Court. *Id.*

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HOWREY INSURANCE IN THE NEWS

ARTICLES

“Emerging Solutions for Risk Transfer in Product Liability,” by **Robert Jacobs** (Washington DC) was published in The John Liner Review, Summer 2009.

Curtis Porterfield, Mike McGaughey and Sanaz Asgharzadeh (Los Angeles) co-authored chapter 35, “Property Insurance In General” in, California Insurance Law and Practice, (Matthew Bender, scheduled publication date: December 2009).

SPEAKING ENGAGEMENTS

On December 1, 2009, **Mary Craig Calkins** (Los Angeles) will present, “Overcoming Complications When Determining the Reasonableness of Defense Costs,” at the American Conference Institute's 15th Annual Advanced Forum on D&O Liability in New York.

On Wednesday, November 18, 1:00pm-2:00pm ET, **Peter Tracey** (Washington DC), **Seth Lamden** (Chicago) and **Stephen Palley** (Washington DC) will present, “Building Insurance Coverage for Construction Projects,” a webinar hosted through RIMS. For further information about this webinar, or to register to attend, please contact Kim Coffee (CoffeeK@howrey.com).

On September 10, 2009 **Catherine Serafin** (Washington DC) presented, “Insurance Requirements: Issues in Risk Mitigation Involving Greenhouse Gases” at the Auditing Roundtable National Meeting in Baltimore, MD.

Ty Childress was co-chair of the HB Litigation Conference: Insurance Litigation: A Crash Course for Associates & Paralegals on October 13, 2009.

NEWS COVERAGE

On September 3, 2009 **David Steuber** (Los Angeles) was quoted in the National Law Journal article, “Broadcom Settles Backdating Case For \$118 Million; Lawyers’ Fees Exceed Amount.”



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