

Catastrophe Insurance (C) Working Group  
San Francisco, CA  
December 7, 2009

Chinese Drywall Hearing

1. Public Hearing Regarding Chinese Drywall

*Commissioner Kevin M. McCarty (FL)*

We are here today to talk about an important subject matter which involves Florida and 22 additional states across the country. This matter is related to the use of Chinese manufactured drywall in residential structures. This matter has captured a lot of public attention among consumers, insurers, health officials, trial attorneys and legislators. While much speculation, or rhetoric, in conjunction with facts and figures is available, there is a large question of what impact this has on the insurance industry. This hearing is a step toward finding a solution. During the course of this hearing, we will be receiving testimony and gathering information in order to guide us toward reasonable solutions. This hearing today should assist us in ascertaining the potential exposures. The items to be addressed include:

- Whether the potential exposure is limited to Chinese drywall manufacturers or manufacturers in other jurisdictions.
- What is the actual problem?
- What is the insurance industry's exposure, if at all?
- What is an appropriate response by state and local governments?
- What states are doing to address the problem? Commissioner Donelon has some news to report in that regard.
- Opinions on what the appropriate solutions might be in the future.

At the conclusion of this hearing, the record will be kept open to take additional comment, testimony and input. A record of the hearing will be made available to the public. The presenters for today represent various sectors regarding the issue of Chinese drywall. They are experts on that subject matter's jurisdiction. Following the presentation we will have a dialogue among the members and invite comment from interested parties.

The materials from today will be available on the National Association of Insurance Commissioners (NAIC) Web site. Our speakers today include:

- Eric Nordman – National Association of Insurance Commissioners (NAIC)
- David Kodama – Property Casualty Insurers Association of America
- Amy Bach – United Policyholders
- Professor Charles Miller – Insurance Law Center

*Eric Nordman, NAIC*

In your packet you have a few handouts. We have also received a number of other documents that are not included in the handouts, some of which will be posted on the National Association of Insurance Commissioners (NAIC) Web site, located in the Catastrophe Insurance (C) Working Group section. I would like to start out with the fact sheet that is in your packet, which is an update on information, which I provided to the Property and Casualty Insurance (C) Committee at its last meeting. There are over 100,000 homes that are potentially associated with the Chinese drywall problem. The latest count from the Consumer Product Safety Commission (CPSC) is that they have over 2,000 complaints in 32 states. The problem being reported for the most part is the smell of rotten eggs, which leads to damage to property. Failure of air conditioning equipment has also been reported, as well as corrosion of pipes, coils, wiring, furniture and fixtures. Some people have also reported damage to jewelry. There is also the potential for bodily injury or health claims. Respiratory problems, sinus infections, bloody noses, headaches, persistent cough—certainly if you have asthma it exacerbates these problems—and fatigue have also been reported.

Some of the claims that have been made deal with the cost to repair the home, the cost of the health effects, plaintiff attorneys' legal fees, defense costs and other various indirect costs, such as loss of use or in some states diminished value. We have seen estimates to repair homes damaged by Chinese drywall exposure ranging from \$8–\$10 billion. The cost of health-related effects at this point is unknown, as we do not know whether these are going to be long-term or short-term

effects. Additionally, we are unsure of how much it is going to take to remediate these effects. Legal fees and indirect costs, such as loss of use, ranges from \$2–\$5 billion. We do not think diminished value is going to be overly expensive because not many states recognize diminished value claims. We are looking at a total cost of \$15–\$25 billion; however, this does not include the unknown costs of the health effects. Additionally, as Commissioner McCarty mentioned, these problems originated in Chinese-manufactured drywall; however, in the last couple of weeks there has been some legal action against National Gypsum and Georgia Pacific. It looks like the drywall problem is ballooning rather than contracting.

We invited the CPSC to participate, but because of the late calling of this hearing they were unable to send a representative. However, there is information in your packet from the CPSC. Nov. 23, they released a press statement related to the Chinese drywall issue. What they found was that there is a strong correlation between homes with the problem drywall and the levels of hydrogen sulfide that is related to the corrosion of various metals in the homes. The press release and the executive summary of that report can be found in your packet, and I would encourage you to include them in the record. An Interagency Drywall Task Force has been appointed. They are developing protocols to identify homes with the corrosive environment and to identify effective remediation of the problem. The study to date has involved a sample of 51 homes. The CPSC has engaged engineering firms to look at it in detail. They tested 41 homes that had complaints of the problems and then a sample set of 10 homes without complaints to get a comparison with the homes that had not reported a problem. They did find that there was a higher level of hydrogen sulfide in the homes with Chinese drywall and that it was causing corrosion of both copper and silver in the homes. Much of the wiring and air conditioning equipment is constructed using those types of metals.

The CPSC also found that the air exchange rates had an influence on the homes which were constructed with Chinese drywall. They found formaldehyde—and this is particularly in newer homes in which elements are sealed out better—also causing the problem of sealing some of the toxins inside. Additionally, large amounts of elemental sulfur were found in the Chinese-manufactured drywall. They have managed to develop testing to identify the element in question. The CPSC is also looking at the long-term safety effects under investigation. The CPSC continues to study the matter and wants to be sure that all of the homes with these problems are reported. One of the things the CPSC is trying to do is to publicize the problem so that anyone who suspects that they have this problem will report it to the CPSC. This way the problem can be tracked, identified and remediated. An identification and remediation protocol team made up of engineers and scientists has also been established. This team will be designing a screening protocol to be used to identify and to test the homes with drywall problems. The team is charged with developing a quick and cost-effective evaluation method and to design the remediation protocols in a cost-effective way. The team will also be studying the long-term health effects associated with Chinese drywall.

In your packet you will also find a bill which has been introduced to Congress. I do not know that there is a bill number—at least it did not have a bill number when the packet was put together last week. This bill is in the House, and it is intended to prevent insurers from cancelling or not renewing homeowners' policies due to the presence of certain types of drywall in the home. One provision that you will probably want to note in the bill is that it does authorize the homeowner to bring a private cause of action against the insurer if they are cancelled. We will keep the Working Group informed regarding the development of this bill in Congress and watch to see if a companion bill is introduced in the Senate.

When we announced this hearing, we also began receiving a number of letters from affected homeowners. This is a little unusual for a public hearing being held for the National Association of Insurance Commissioners, as we do not tend to get many of these. However, we received many. We gave some thought to distributing them, but once we started reading them we found a lot of personal information included in the letters. Additionally, we had pictures of houses and copies of people's declaration pages. We decided that we should not put this type of information out on the Internet, as it might invite identity theft. We will go through the letters after the hearing and redact personal information and put out a generic outline of the type of things people are complaining about. Essentially, these letters contained complaints about policy cancellations, the drywall, complaints regarding the effects that have been noted in the CPSC study and announcement, and some heart-breaking stories about people that are locked out of their houses because of the health conditions of it, facing a fairly serious bill and just wondering what to do.

We did have some complaints about health issues as well, and we will document and list those for you. Most of the complaints were in regard to the smell and corrosion. In many cases people had abandoned their houses and gone to stay in other places. In many cases these houses have serious problems and these folks are looking for remedies. I would be glad to answer any questions you might have.

*Commissioner Chaney (MS):* Have we given any thought at all as to trying to look at the Chinese government for some of this responsibility? I have some real doubts in my mind whether insurance companies should be responsible for a lot of this.

*Mr. Nordman:* I think what you are looking at here is a product liability claim, and I do not know that this would include the Chinese government, as you really have a Chinese manufacturer. I think it is pretty uncertain as to what sort of reach our courts have to a Chinese manufacturer. You are probably looking at situations where everybody under the sun will get sued for this—the installer, the seller of the drywall and the manufacturer, if they can be found. Then they will let the courts try to sort that out. I do think that it is not a bad idea to go to the Chinese government and see if they will do something to make this right. I do not know if that has happened yet; however, I do not think so.

*Commissioner Chaney:* Mississippi had the first actual case filed on Chinese drywall. I do not think we have a lot of Chinese drywall in our state, but be that as it may, we have the first case. I do think there is some precedence on the Foreign Sovereignty Immunity Act in which companies, and even the federal government, could take some type of action against the supplier of the Chinese drywall. It looks like this is an issue that is not going to go away for a long time.

*Commissioner McCarty:* I do know—however, I do not know the source—that the U.S. trade officials are aware of this issue and have been in contact with certain officials in the Chinese government. I will get more details on the status. You are right; part of the remedy for this is to have a fund set up. Hopefully this will be funded by the people responsible for the production of the product.

*David Kodama – Property Casualty Insurers Association of America*

Chairman McRaith, Commissioner McCarty and members of the Catastrophe Insurance Working Group, my name is David Kodama and I am senior director of research and policy analysis for the Property Casualty Insurers Association of America (PCI). PCI is a trade association representing over 1,000 property casualty insurers that write over 30% of the homeowners insurance sold in the United States. Because of that, we have a deep interest in the issues that affect that market. The following are statements regarding your effort to obtain information on the implications arising from the alleged defective Chinese drywall installed in many of our nation's homes.

Chinese drywall is at the center of a complicated issue for all concerned. It is complicated because at the moment there are many questions and few answers. It is complicated because there is *correlation* between the drywall and problems in people's homes but no demonstrated chain of *causation* thus far. It is complicated because people are reporting physical health symptoms but not consistent symptoms. It is further complicated because neither homeowners nor general liability policies are construction warranties. As insurers, PCI members want to help their customers, but must do so within the confines of each insurance contract, as that contract applies to each individual claim situation.

Chinese drywall became a public policy issue early in 2009, with early news media reports of problems in houses containing Chinese drywall. Throughout the year, PCI has worked to provide our members with timely, *factual* information. As with many complicated issues, separating fact from hype has been a key to determining the best response for both consumers and insurers.

An unfortunate controversy arose when a state-run insurer of last resort announced that it would not renew homeowner's policies on homes containing Chinese drywall. While this was a state-owned insurer and the action was rescinded, our entire industry's public reputation suffered in the resulting news media coverage. Private insurers continue to operate under the terms of their policy contracts and state-regulated insurance practices.

Insurers are familiar with a concept called "the chain of causation." Problems rarely just spontaneously happen; they are usually the result of a chain of causes. Removing just one link generally breaks the chain and prevents the problem. A fire resulting from careless smoking is a classic example. A person is smoking in bed and falls asleep, dropping the cigarette. The cigarette smolders for some time before igniting the bedding, but the battery in the smoke detector is dead. The resulting fire burns down the house and kills the occupant. If just one component of the scenario changes—not smoking in bed, not falling asleep while smoking, the smoke detector working—the fire is averted.

Something similar will likely be found true with Chinese drywall. We just do not know all of the links in the chain yet. The Consumer Product Safety Commission and the Florida Department of Health have taken the lead in coordinating the work of many government agencies that are searching for the actual cause-and-effect relationships so that solutions can be developed that will allow people to enjoy living in their homes. Once the *actual* cause or causes of the odors, metal corrosion and health complaints are found, all stakeholders can properly evaluate how they can best make the situation better. As I said at the beginning of my comments, this is a complicated issue. We have correlation but we must find causation in order to truly resolve the real problem.

Government investigators have completed preliminary testing of drywall samples. They have found differences in the makeup of domestic and Chinese drywall, but not exactly how that may impact gaseous emissions reported by homeowners. They have tested air inside and outside houses, but found the highest levels of sulfur outside rather than inside. They reported finding hundreds of thousands of sheets of drywall in warehouses but did not report sulfurous odors in those warehouses. They recommended expanding their investigation to include chemical reactions, which is only logical, since drywall is not left bare inside living spaces. We hope that these and other investigations will quickly lead to practical alternatives that will minimize disruption to families when the odor problems are addressed. Research results to-date are helping to identify the links in the chain of causation concerning Chinese drywall.

Even with these preliminary results, federal and state investigators have developed recommendations to help families stay in their homes. These include bringing fresh air into the building, dehumidifying (often through the air conditioning system), keeping the indoor temperature cooler, and spending time outdoors. As more definite research results come in, we expect that these recommendations will be refined and become more focused.

While research into breaking the chain of causation continues, several sources of financial assistance have emerged for homeowners. Some affected homeowners will have discovered a problem within the warranty period on new or renovated homes. At least one state government has set aside funds to help homeowners, and legislation has been proposed that would make low-interest loans available to help homeowners make repairs, if needed. We applaud the Knauf Plasterboard Tianjin Company's willingness to respond in U.S. court to at least one class action lawsuit, and hope that other drywall manufacturers will actively engage in solving the causation riddle. Determining why problems emerge in some houses and not others should lead to cost-effective ways to stop problems by breaking the weakest link in the chain of causation.

Many here will see the similarities between the current situation and the early months of the mold issue a decade ago, including the rush to litigation. As with mold, we expect scientific, *factual* knowledge will lead to the most effective ways to deal with the challenges associated with Chinese drywall.

In the meantime, insurers will continue to evaluate each claim presented based on the individual claim investigation and the provisions of the applicable insurance contract, within the context of state insurance regulations. The same is true for any underwriting actions that insurers may contemplate. Everyone must remember that an insurance policy is a legal contract that spells out the duties and options of each party, and that it is not a construction warranty.

As I said at the beginning of these comments, Chinese drywall presents a complicated issue for all concerned. It is complicated because there are many questions and few answers. It is complicated because there is correlation between the drywall and problems in people's homes, but no demonstrated chain of causation thus far. It is complicated because people are reporting physical health symptoms but not consistent symptoms. It is further complicated because neither homeowners nor general liability policies are construction warranties. As insurers, PCI members want to take care of their customers, but must do it within the confines of each insurance contract as that contract applies to each claim situation.

Again, let me thank you on behalf of PCI and our members for the opportunity to appear before you today and provide you with our input on this issue. PCI and its members look forward to working with you further.

*Commissioner McCarty:* I want to thank you for taking the time to make a presentation today. This is a very challenging question for the industry as well as for consumers. The available information oftentimes has made it more challenging in trying to address the causation issues. Are there any questions from members of the Working Group? Are there any comments with regard to the testimony? Thank you very much.

Next we have a presentation by one of our funded consumer advocates on behalf of United Policyholders—Amy Bach.

*Amy Bach—United Policyholders*

I appreciate the opportunity to present some information to the group. It was also very helpful for me to get up to speed on this issue in a short period of time. I think those of you in the states where the complaints have been coming in have gathered information in a relatively short period of time. As Mr. Kodama said, I think those of us who have been at this for some time see parallels in the great concern and response around mold. Unfortunately, I think there are going to be some parallels with the post-Katrina struggles that many of the homeowners in the hurricane states had with their insurers regarding coverage where causation issues are being litigated. Sometimes people's common-sense feeling about how things should turn out may not always happen. This is often due to the complicated wording in insurance policies and the legal decisions concerning causation and anti-concurrent causation exclusions, which are problematic.

I appreciate your attention. I distributed a copy of what I thought would be my slides, so if you have questions after the presentation I have listed our Web site. Additionally, you can always e-mail me at [amy@uphelp.org](mailto:amy@uphelp.org). I think a lot of you have already heard about our organization. I will just briefly say we are a 501(c)(3) funded by donations, foundation grants and book sales—a Large Disaster Handbook that we publish. We have been around since 1991 and we do a lot of work in areas where there has been a natural disaster. Our advisors include individual insureds, commercial insureds, insurance industry professionals, attorneys, other financial services professionals such as CPAs, enrolled agents, and construction professionals. We have three programs through which our work is done. These programs are made up of roadmap to recovery; roadmap to preparedness; and our amicus project and advocacy work.

Mr. Nordman did a great job at reviewing the background facts. Again, Chinese drywall was imported into the country between 2005 and 2007 when a housing boom and two active hurricane seasons created a shortage of building materials in the southern United States. My understanding is that the product is not necessarily cheaper than domestic drywall, just that it was available. It is stamped “Made in China,” so when you do destructive testing, it is easily identified. It is believed that no new shipments have entered the country this year. There was some question about there being a shipment in March that was sitting in the port. The tricky part is that some of this drywall has already been recycled and possibly mixed in with United States-made drywall. The damages—as you have already heard— include odor and corrosion pitting. Some construction professionals that I have talked with feel that they can walk through a building and see the evidence, even in a mirror that is hanging on a wall. However, the most clearly manifested damage that can be seen is to air conditioning coils and in pipes that are close to where the drywall has been installed. I have seen photos of normal coils and coils that have been near this product. The coils that have been near the product are clearly identifiable.

Home not so sweet home, the materials have been found by state and federal agencies to emit volatile sulfur compounds and produce a rotten egg odor. Homeowners complain the fumes are corroding copper pipes, destroying televisions and air conditioning, blackening jewelry and silverware, and making them sick. This comes from an Associated Press story that came out at the same time the CPSC released their findings Nov. 23. The study was done by a research firm—Environmental Health and Engineering, which was on contract with the CPSC. There were actually three preliminary scientific reports with regard to a 51-home indoor air study, an electrical component corrosion study and a fire safety component corrosion study. Mr. Nordman has given you the link to the summary of this study and noted that the 51-home study did find a strong association between the problem drywall and the hydrogen sulfide levels in homes with the problem drywall and corrosion. The CPSC has set up a drywall information center, and I have given you a link to this site in the reference sources page. This site is jointly supported by the CPSC, the federal health agency and two other entities. As Mr. Nordman mentioned, the CPSC has reached out to the governors in all states asking that they provide Chinese drywall complaint data by Dec. 14, 2009. If you have not already assisted in this effort, I encourage you to do so.

The scope of the problem is obviously what is on everyone’s mind, including the insurance carriers that you regulate, as well as your own insurance departments. I would caution the group on relying too much at the projected dollar payouts, as doing so can lead to result-driven decision-making. The CPSC has received nearly 2,276 reports from 32 states. The problem seems to be most serious in Florida, Louisiana and Virginia; however, Florida has definitely been the state hardest hit. A large number of the CPSC drywall complaints—1,522—have come from Florida homeowners, and it is possible that approximately 35,000 homes in the state may contain Chinese drywall. This information comes from an article published in the *South Florida Business Journal* in September. An estimated 550 million pounds of this product are estimated to have entered the country, which is enough drywall to construct 60,000 average-size homes. If the Chinese drywall was only used in new construction, we are thinking about 60,000 homes; but since a lot of it was just used for repairs, this is just a number.

Cost to repair—The National Association of Homebuilders testified before Congress. It will probably cost between a third of a home’s value and \$100,000 to repair the damage caused by Chinese drywall. Meanwhile, a major builder—Lennar Homes—disclosed in a recent financial filing that it has set aside \$100,000 per home to remediate houses that it built with Chinese drywall. Both commercial and residential insurers are impacted. I want to note that our organization does not just represent individual insurance consumers; we also represent businesses that have purchased insurance. This issue is going to impact property owners, renters, builders and contractors, and material suppliers, all of whom may have insurance and resulting issues.

Insurance headaches—the following is from an article that appeared last week in Commissioner Donelon’s hometown paper: “Insurance has been one of the major headaches for consumers with Chinese drywall because carriers have universally been denying claims and in some cases dropping coverage for people who make them.” Obviously, we know this issue is hot already because of the bill that has been introduced in the House of Representatives. I know some of you are already engaged in helping the policyholders in your state who have gotten a non-renewal notice and believe that it is related to their drywall claim. As you know, probably most all of the consumers affected here on the residential side are already experiencing

financial problems and need insurance money to repair. Additionally, there is a quote that appeared in the Bradenton Herald in Commissioner McCarty's area. It says, "Those of us affected by it are already stuck in a bad spot between our mortgage and not being able to live in a home that was paid for. It is one more, scary thing to worry about."

Another story that has appeared in the paper talks about how many of the people who had this drywall installed had already been hit by the hurricanes, which is why this drywall was installed. They lost a home in the hurricane and fought back, and now they are hit again. "After Katrina dropped three trees on the roof of her home in Folsom, LA, Lucille Borden built a new home and moved into the home in December 2006. Since building the home her air conditioning has failed several times, her water heater split and she feels constantly fatigued. I do not blame her. Since then, her water faucets have developed strange pock marks—that is that pitting I was referring to earlier. Her mirrors and silverware have turned black, and in August she discovered that her new home was filled with Chinese drywall. Like most Chinese drywall victims, Borden filed a claim to her homeowners insurance without success. Her insurer, State Farm Fire and Casualty Company, sent an inspector to thoroughly document the damage, and subsequently denied the claim. 'My insurance will not take care of it,' says Borden, 79, who is now living in a trailer on her property until she figures out how to fix her home. 'They say they do not cover pollution. We cannot get any help from anybody.'"

Obviously, homeowners who have now found this problem need the insurance money to make repairs, and they now fear losing their coverage, so we have two issues that they are dealing with. Homeowners are already in a bind, and it is looking like some of them may lose their coverage. Again, we really need to be gathering data, not panicking ourselves, and helping insurers and property owners and businesses to stay calm. This is a quote from the Miami Herald: "Many homeowners have filed the claims that is turning out to be a dead end. Property insurers are denying the claims, saying homeowners policies do not cover contamination or building material defects." I am going to very briefly identify some of the reasons that carriers are saying they are not covered, and then Charles Miller will give you a little more detail when he testifies.

The question is does an insurer want to cover or not want to cover a loss resulting from Chinese drywall damage. From an article that appeared last week in a Louisiana paper: "State Farm and Allstate—Louisiana's largest residential insurers, with about half of the households in the state—say they have denied claims because they believe that coverage would be excluded because the drywall is a defective material. But George Sutton, a representative of Louisiana Farm Bureau—a top-five insurer in the state—said, 'Farm Bureau believes that while the drywall would not be covered because it is defective, and this is really the key here, any losses caused indirectly by the drywall such as corroded appliances and wiring or furniture that absorb the toxins would be covered. It is my opinion,' he said, 'that ensuing losses under drywall would be covered, and that is where I hear echoes of Katrina. That is why we feel strongly as a policyholder advocate that this is not an open-and-shut case by any means, and there are a lot of bases under which these claims can be covered under both commercial and residential forms.'" The article went on to say that is good news—while people may be disappointed the drywall would not be covered, the cost of replacing wall board pales in comparison with the cost of re-wiring a house or possibly demolishing it if the studs are corroded.

Briefly, regarding homeowners policies, the carriers have been arguing so far there is no coverage due to the following: defective product; latent defect; and pollutant.

As you all know, in residential policies there are generally two types of policies—"all risk" and "named perils." There are a lot of exclusions in "all risk" policies with regard to the items listed above. These are typically going to be limited to dwelling coverage. A named-peril policy for personal property includes 16 specific perils. There are going to be a lot of issues here to grapple with. Commercial insurers are also fighting coverage denials. Commercial General Liability (CGL) coverage disputes are under way. There is quite a bit of litigation under way at the federal and state level. Issues include not only the usual exclusions, but what is called your work, your product exclusion that is seen in the commercial property form—CP OO 17—pollution exclusion, impaired property exclusion, and then fighting over single or multiple occurrences—for example as with the September 2001 World Trade Center claims. Policyholders are countering. It is not excluded because it is not pollution. It is not excluded as a defective product because of the ensuing loss, and again I think this is an important point that I want to drive home. Chinese drywall damage should be covered because it is direct, physical loss or damage to property, and it is hard to get your mind around this. If you think about it you can see that odor, which causes illness and inhabitation, is a direct physical loss. Additionally, you have clear physical damage to pipes, fixtures, etc., ensuing in resulting losses covered, even if a defective product was the cause. And this brings us to the legal issues.

Courts will definitely be determining outcomes here, but regulators can help. I have given you a quote from a 2009 case out of Massachusetts where the court said, "We feel that odor can constitute physical injury to property and reasons why Chinese drywall is unlikely to be determined by courts to be a pollutant. The pollution exclusion has been found just to apply to industrial waste, widespread environmental contamination and active polluters. If an agent does not constitute a pollutant drywall, and we do not believe it will fall into that category, then it will not be subject to that exclusion and possibly no

release into the atmosphere.” We will see about that. From a policyholder’s perspective, my insurer should pay for safe removal, repair, replace, pay for the fix, restore my home to a habitable condition and then go after who you think is responsible. Use the subrogation process, but help me out here.

Regulators can issue formal opinions and file amicus briefs supporting policyholders’ arguments as to why drywall claims are—or should be—covered. Act swiftly to stop non-renewals of the drywall claimants’ policies. You can use whatever existing authority you have, as Commissioner Donelon and Commissioner McCarty have been doing. Seek additional authority and work together on this. Be responsive to consumer complaints. I have cited a release in which Commissioner Donelon says, “Help available for victims of Chinese drywall.” I commend you for providing the sources that help. I am going to add one thing that was not in my remarks and that is to work with the carriers on removal protocols. I actually chatted with Dave Snyder (American Insurance Association) about this yesterday. Much like in the mold situation, you know you will have a whole cottage industry develop consisting of Hazmat guys scaring people into believing that you cannot remove it, you have got to have a suit and suddenly a \$5,000 fix becomes a \$20,000. We definitely want to have some protocols for removal that property owners can look to calm themselves on how to safely remove the drywall.

I just want to acknowledge and thank those who helped me gather data quickly for this presentation, my colleague Colleen Reppeto with FIRM, Robert Horkovich from the New York-based firm of Anderson Kill and Olick, and attorney Ed Eshoo of Childress Duffy Goldblatt in Chicago, who has offices in Florida and put together a very useful presentation which I have asked him for permission to share. I have given you the two reference sources. Again, I thank you for your time.

*Commissioner McCarty:* Thank you, Ms. Bach. Are there any questions from the members of the Working Group? Are there any comments from the interested parties? Commissioner?

*Commissioner Chaney:* Amy, good presentation. We have had some experience with the pollution exclusion in our state—that unfortunately, I am not happy with—but the circuit court has ruled that certain subsequent events are covered by the pollution exclusion. If you all look very closely at where you’re headed down the trail, it is really going to affect Commissioner Donelon.

*Ms. Bach:* The pollution exclusion has been litigated probably more than any exclusion ever written. There have been a lot of differing opinions around the country in different jurisdictions, both state and federal. We have lots of experts in our family that have been involved in those matters on both sides, and I cannot answer it specifically as to Mississippi. Mr. Miller may have some insights, but I am happy to stay in touch with you on this and help however I can. We have filed many amicus briefs over the years in pollution exclusion fights, and most of them are up on our Web site for review.

*Commissioner McCarty:* Are there any other questions? I think if I understand what you are saying, and I know you are a very strong proponent of insurance companies paying claims in accordance with the terms and conditions of the contract—and I applaud you for the work you’ve done over the years—but in this case it seems to me—part of what you are saying is—it may be covered or it may not be covered, but whether or not the claim is covered, insurance companies should pay the claim and then go after whoever is responsible because you are in the inferior position of negotiating with the parties that are responsible. Is that a fair characterization?

*Ms. Bach:* That is a fair characterization because the people whose cases are still being litigated from the 2005 hurricanes are here to tell you that this is not the way to go. A lot of insurers have gotten a lot of black eyes from people feeling like, “oh yeah, sure, all the promises in the world and then when I really need you, you are not there.” This is a classic sudden and accidental, unanticipated “my house was okay and now it is not, it is an accident and I don’t understand what you are talking about here.”

*Commissioner McCarty:* I think I can see that argument more persuasively with regard to homes that are repaired in the aftermath of a storm rather than putting in faulty material. We have a lot of the ones in my state and the ones that I’ve been dealing with directly—new construction. I think the industry feels as though they haven’t collected a premium for this risk and, not to be schilling for the industry today, but it does seem to be plausible argument; it certainly is not anticipated in the collection of the premium that a defective material—it is indisputable that it is defective material—is precipitating the damage. Whether or not the ensuing loss is covered is another story. Clearly, the defective material is not, would you agree?

*Ms. Bach:* Not necessarily. It is my understanding that the drywall that is being stored in warehouses does not smell because it has not been exposed to moisture. The exposure to moisture is the combination of peril—that different event where you have it acting in combination with something causing the resulting loss.

*Commissioner McCarty:* Commissioner, further questions?

*Commissioner Chaney:* Ms. Bach, the reason I mention the pollution exclusion was that the court found that the chain of events—the pollution itself may be covered—but the events that followed it were not and that bothers us. And when you have consumers that have been kicked in the teeth—they've lost their homes—and the reason we don't have a lot of Chinese drywall in Mississippi is that we couldn't get rebuilt fast enough, and we still don't have anything there—and then you compound that—and we probably don't want to talk about it but it needs to be said—that some of these companies are pulling out of the state. They write in our state, or in Louisiana, or in Florida, they will bankrupt it and move on and non-renew and terminate. It is a fact, we have to live with it; this has more potential to exceed the losses to the consumers than all of the monies we paid out through FEMA for Katrina.

*Ms. Bach:* Commissioner I certainly hope that is not the case. I feel that the numbers that are coming in suggest that it isn't, but obviously we are still trying to get our arms around how big this is.

*Commissioner Chaney:* The issue with the Chinese drywall is—and I have read quite a bit on it—but I don't understand if you have got a compound that's got sulfur in it and it is not released, and the calcium sulfides in it binds with water and the copper oxides bind with water, then you get hydrogen sulfide and that is what kills you. That is what causes all of the problems and somewhere this thing may not hit you for four or five years; it's like the lead paint on children's toys. I'm not taking up for the insurance companies, I'm just saying there's got to be some common ground and that we all look for a common solution. One of solutions needs to include an advocate, and we need to tell our government if we are going to enforce environmental laws in this country, we need to enforce the environmental laws in other countries that are importing products into our country. In part of my other life, I was in the wood treating business—a very toxic business to be in—but pentachlorophenol, when it is made, dioxins are created and they are around for a long time. We've outlawed the making of pentachlorophenol in this country. Currently it is all made in Mexico, but we still import pentachlorophenol. It is the same principle as with Chinese drywall; all I'm saying to you is that we need to all work together not to throw the blame on somebody else. This is a long-term problem.

*Commissioner McCarty:* You make a very good point that humidity plays a major factor. From the public hearings that we've had in Florida—and the problem is exacerbated in Florida—only suggests that in other areas of the country it is more of a latent defect and it will materialize sometime in the future. While it is true that right now this is a southern problem due to the humidity, homes constructed anywhere during that time period could in fact be constructed with Chinese drywall.

*Commissioner Chaney:* I don't want to get off on the fact that some of our consumers in the coastal areas are already paying for a lot of risk and that rates have gone up 300-400% on property and casualty insurance. Companies are non-renewing and if you look at the potential here, the companies will try to capture that risk upfront, no question about it. I don't know if we can stand another 100% increase every year for the next three years; it's just mind-boggling to me as a regulator as to how we are going to get our hands around it.

*Ms. Bach:* I think that staying close to the data and avoiding these big number, “oh my gosh” types of dialogue and we might have to pay out X is probably a good way to go.

*Commissioner Chaney:* Ms. Bach, has your consumer advocate group tried to track where all of this drywall was brought in to and where it was installed? Nobody seems to be able to tell us.

*Ms. Bach:* I think, as Commissioner McCarty mentioned, there already are some meetings under way, and as Mr. Kodama mentioned, Knauf is the company that manufactured the most of it and they have answered at least one of the suits; I think they've defaulted in some of them too. There have definitely been either meetings under way or overtures—and it is a delicate trade issue, there is no question about it.

*Commissioner McCarty:* A lot of discussion in terms of the state and national level as to some kind of a funding source that might be necessary to assist policyholders—if, in fact, as opposed to going through protracted litigation when these people are (really many of them are) being re-victimized in terms of hurricane and then building products too—to find a way of building the homes and then resolving who is ultimately responsible later on.

We thank you again for your testimony here. Lastly, we have Charles Miller.

*Charles Miller, Insurance Law Center*

For the last 19 years I've been practicing law in California. Most of my practice has been in insurance law, and prior to that, for 18 years, I worked in the insurance industry. I worked for a large national insurer in their claims operation. I've also had the privilege to consult and work with attorneys around the country on a variety of insurance issues and cases. I've had the chance to be in Mississippi after Katrina and work on many of the cases there, as is the case also in Florida, Texas, Louisiana following the hurricanes in 2004-2005, and then again most recently in Texas. I've seen a lot of disasters from the standpoint of being a lawyer as well as someone in the insurance industry—the Loma Prieta earthquake, the Oakland Hill fire—I worked on those. I think I have some perspective that may assist you in evaluating these cases and looking at how the insurance industry is handling or not handling them.

The purpose of my presentation today is not to discuss all of the factual issues behind the Chinese drywall matter; those have been elucidated and discussed fairly well here already by others. We all recognize that this is a widespread and very serious problem. What I want to do today is maybe not talk to you so much about case law and judicial decisions—although I will do a little of that—but I want to talk about how the insurance industry itself has interpreted some of the key policy provisions that the industry is now relying on to deny coverage, almost universally in these cases. In both the homeowners cases where people are seeking compensation or help to repair their homes, and in the liability insurance field—principally commercial liability policies where policyholders (commercial entities) are seeking defense and indemnity from their policies. Many policyholders haven't turned to their insurers for this kind of assistance.

From an insurance perspective, I believe that the issues are two-fold:

- Are the insurers properly applying the insurance policies to the claims that are being presented?
- Are the insurers properly investigating and evaluating those claims?

These two go hand in hand, I can testify to that from personal experience. Without a proper and thorough investigation, there cannot be proper evaluation of claims.

From a regulatory perspective, I suggest that the issues are somewhat different, again two-fold:

- What role can the insurance regulator take in helping to ensure that insurers are properly evaluating and applying their insurance policies?
- What role can the insurance regulator take in addressing the overall problem presented to homeowners arising from Chinese drywall?

I hope to be able to touch on both of these issues in my discussion here today, but before proceeding to specific insurance policy issues, I think it is important to recognize that they have a context, and that context are the standards used in the insurance industry and legally as well to interpret and evaluate and apply insurance policies. These standards are taught to insurance claims personnel. They appear in text used nationally to train them. They appear in other publications such as the Fidelity Casualty and Surety Bulletins or the International Risk Management Institute publications. These are not unknown to the insurance industry, and they are critical in evaluating the industry's response to the Chinese drywall claims. So what are they, briefly? We have heard them before, but I will go over them quickly. Exclusions are to be interpreted narrowly. Insuring agreements broadly interpreted. Policy language must be given its plain, ordinary, and popular meaning. I am not quoting here from cases. I am quoting here from texts and materials used in the insurance industry. I am also going to quote now from the Fidelity Casualty and Surety (FC&S) publication in June 2004 titled "That Particular Part." The burden is on the insurer to establish the fact that exclusions apply. The insurer simply stating that coverage is excluded is not enough to settle the issue. The insurer must prove its case and if there is any reasonable doubt as to the application of the exclusion and the insured is entitled to the benefit of the doubt. Exclusions are to be construed strictly against the insurer. It is important for us—and now this is me talking—for us to appreciate the importance of these standards that the insurance industry uses itself in evaluating how the industry is responding to these claims and whether they indeed are following their own standards—standards that I also applied when I was in the industry.

So what are some of the issues? We know what these issues are, and the insurance industry has made that well-known, as well as the people talking here today. But let's talk again about them and how the industry interprets them from the standpoint of homeowners policies. The pollution exclusion—this is the big one. The FC&S bulletin has recently noted in its own publication regarding the Chinese drywall issues that many courts have noted the exclusion only applies to traditional environmental damage. We have such cases in California as well—appellate court decisions; traditional environmental damage. The release of gasses inside of a residence is not normally considered to be traditional environmental damage. I want to say one more thing about the pollution exclusion. The so-called total pollution exclusion—some of you may remember this—was brought into play in the mid 1990s by the insurance industry, and at that time there was testimony before ISO from insurance company representatives regarding this new total pollution exclusion that was going to replace the sudden and

accidental pollution exclusion, and that testimony was to the effect that some of the members of the insurance industry themselves realized that it was going to be hard to apply and that it was ambiguous in many regards as to what was a pollutant. But we are going to go forward with it anyway, and they did without making any changes to the proposed exclusion, even though they themselves recognized that it was going to be difficult to apply. If it is going to be difficult to apply, then let's go back to that basic principle of application in that circumstance, it should be applied in favor of coverage for the policyholder.

The other one that is getting a lot of news lately—and you know I get into this insurance stuff, this is what I do. A lot of people do not do that sort of thing so when you see insurance provisions get a lot of news I get excited, but that is my life. The inherent vice and latent defect exclusion: How does the insurance industry interpret that and now I am going to quote from William Rodda's book Fire and Property Insurance: "In the insurance industry the latent defect or inherent vice exclusion is defined as a quality within an object which makes it tend to destroy itself. The tendency of rubber to deteriorate whether or not it is in use is an inherent quality of the material and an inherent vice, but that is not the only place where this comes from." Let's go again to the FC&S bulletin: "A loss due to a quality in the property that causes the property to damage or destroy itself that results from something within the property itself as opposed to some outside force." There are other sources in the industry similar to this, but what does this tell us in this particular case? Is the drywall destroying itself? I do not think there is any evidence of that. It is not a latent defect by the insurance industry's own interpretation of that exclusion. Certainly, the resulting damage would not be excluded under these definitions as well.

Another exclusion that is getting a good deal of play is the construction defect exclusions in the homeowners HO-3 policies for faulty materials, workmanship, etc. In June 2009, FC&S again weighed into this issue and I think appropriately and correctly. FC&S has noted that any ensuing loss from improper workmanship as a result of the faulty drywall would be covered, for example, if the drywall caused corrosion damage to wires or pipes. That is a direct quotation from the FC&S. I consult with them frequently on coverage issues. I call them up. I know a few people over there—Diane Richardson and a few other people. I find them very well-informed and very helpful. I know they provide advice to the industry in many different ways and people follow their advice in the insurance industry. I suggest that they start doing so now as well.

Litigation is commencing with homeowners—for example, March 30, 2009, the case of Baker vs. American Home Assurance Company was filed in the middle district of Florida. The complaint alleged, and this I hope will be of interest to you, that the insurer had the home tested by Rimkus Consulting Group, but refused to turn over the report to the policyholder. The complaint also alleged that the insurer failed to provide written denial, but only denied coverage verbally. Let's assume for a moment that those are accurate allegations. I think they would cause us a great deal of concern, not only from my perspective, but from the perspective of regulators as well.

The homeowners issues are not the only ones, as we well know. There are significant issues under the commercial general liability policies as well. The first one, again, is the pollution exclusion, and again I turn to the FC&S bulletin, the insurance industry's own source. The exclusion was intended to limit or exclude coverage for environmental contamination and not product liability claims. The damages from drywall are not environmental pollution, but rather bodily injury or damage by products containing the sulfur compounds. I think that is an accurate assessment in the scope of that exclusion in the context of commercial liability policies.

The work exclusion has a nice exception in it. For work done by subcontractors—it is critically important to recognize that coverage is provided there if the work is done by a subcontractor, and that coverage need be evaluated accordingly. The second exception reads as follows, "that particular part of any property that must be restored, repaired, replaced because the work was incorrectly performed on it." There are massive, lengthy articles about trying to understand the language in this particular exclusion in the CGL, but nonetheless, this exclusion does not apply to property damage in completed operations hazard. The litigation, again, is commencing rapidly. In April 2009 the action of Builders Mutual Insurance Company and Fireman's Fund and Hanover vs. Dragus Company was filed in federal district court in Virginia. The insurer brought that action against the insured, contending that the insurers did not owe an obligation to defend or indemnify the insured from actions brought against the builder arising from Chinese drywall cases. Builders Mutual denied coverage less than two months following the tender based upon the pollution exclusion, giving rise to at least some question about the thoroughness if their evaluation and investigation. The drywall in that case was installed by a subcontractor of Dragus, yet part of the insurer's denial was based on the work exclusion. There is much to talk about in regard to these exclusions and insurance coverage issues which cannot be done here today.

I hope that this summary has been helpful, but we are still left with the question that I asked to begin with—what can the regulators do? I would suggest to you that there are some steps that you can take today as regulators that would be very effective in protecting policyholders around the country with regard to Chinese drywall cases. There is, as I pointed out, a critically important relationship between a timely and thorough investigation and a proper evaluation of the coverages. The

commissioners may want to consider, as has been done before in other contexts, a multi-state market conduct exam to ensure that proper investigations are being conducted. Such a multi-state examination could include a representative of insurance consumers. Authority is commonly provided to commissioners under their respective state's statutes regarding market conduct exams to hire such outside consultants. This, in my view, would tend to add greater insurance to the general public that their interests are being covered in the examination process. Of course, the results of such an examination should in no way be prejudicial or determinative of the issues that may arise in any private litigation brought about by a policyholder. Secondly, I would also suggest that the commissioners explore the possibility of developing a model guidance document to the insurance industry to be issued to the insurers regarding the manner in which the commissioners expect the applicable insurance provisions be interpreted and applied.

Earlier during this discussion today, there was an appropriate discussion about the need to find a universal solution to bring all of the parties together. Unlike Katrina, we couldn't bring the storm to the table; all the policyholders had to deal with then were the insurance companies. In this case, there are a lot of entities to be brought to the table—the insurance industry, the manufacturers, the builders, so on and so forth. When I was thinking about this when the question was raised earlier about trying to find a more universal solution, I recalled what we were dealing with in the 1970s with the asbestos issue. There were thousands of claims being presented all over the country, and the industry and many others were incurring massive transaction costs. In a response to that, an effort was made to consolidate those cases and develop a funding system for the victims of asbestosis by the insurance industry and the manufacturers together; it was quite an accomplishment. Why isn't that model being considered today, because it is the potential here to solve a problem rather than be one? I do hope that as commissioners and regulators you join in that solution. Thank you very much for the opportunity of allowing me to be here today. If you have any questions, I would be happy to try to address them.

*Commissioner McCarty:* Thank you very much. We really appreciate your information; I think it is very valuable for our consideration. Are there any questions? I would just like to follow up on your menu of potential solutions in terms of what regulators can do. One of the last things mentioned was to explore a model guidance document and that there is precedence set for this. Perhaps you can help me, but I can't recall us providing guidance on the payment of claims.

*Mr. Miller:* The insurance departments of Texas and Colorado have both published guidance documents on how they expect insurance companies to pay overhead and profit in first-party property claims under homeowners policies and how the provisions in those standard-form policies should be applied with regard to overhead and profit. This is an example of what I was talking about. I have seen other examples, but that is the one that comes to mind right away.

*Commissioner McCarty:* OK, thank you. Are there other questions? Commissioner Donelon?

*Commissioner Donelon:* Thank you, Mr. Chairman. Mr. Miller, you also talked about the asbestos precedent that was set. Can you perhaps expound on that a little bit?

*Mr. Miller:* I was just thinking about this today when I was listening to the Commissioner of Mississippi talk about it, and I would have to go back and do my own research, but the basic idea as I mentioned was there was an effort to bring together stakeholders and to provide a large fund for compensation.

*Commissioner Chaney:* Just a quick observation: Mr. Miller, in the asbestos cases, you know we paid the trial bar about 40%. If we preempt them, I am worried that in Mississippi they may sue me for cutting them out of a fee.

*Commissioner McCarty:* Again, thank you very much. This was valuable information and we will look forward to having you answer follow-up questions if they arise. This concludes our planned presentations for today. I would certainly be remiss if I did not invite our interested parties in our audience to comment with regard to the issue in general or with specifics in regard to the testimony we have heard today.

[There were no comments from interested parties or other members.]

*Commissioner McCarty:* The record is being left open to augment any of the comments that have been made and to take any additional testimony. We are looking forward to developing a report and perhaps recommendations to the management team. Show us adjourned. Thank you.

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