

By Robert J. Prah, CPCU

MOLD: THE \$1 BILLION CHALLENGE

Skyrocketing claims drive the search for solutions

The mold “explosion” over the past two years has had a severe impact on the insurance business. In 2001 alone, mold claims cost homeowners insurers more than \$1 billion, five times the cost in 2000.

The industry has had its hands full this past year working to develop and obtain approval for mold exclusions, as well as limited buy-back coverage options for mold claims.

This article focuses on the mold situation and examines the industry response to the problem, with an emphasis on how AAIS has responded.

Aside from beer, wine, cheese, mushrooms, and penicillin (some of the good or beneficial things that come from mold), the fungus has of late created panic in the minds of consumers, a bonanza for plaintiff’s lawyers, and havoc for the insurance industry.

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What events precipitated the mold problem?

Although the issue of mold as a dilemma for the industry is relatively new, mold is found virtually everywhere and has been with us since the beginning of life itself. Actually, it is a critical part of the ecosystem, providing enzymes that break down and recycle dead organic materials. Mold clearly serves a purpose, but precautions are needed to control the invasion or spread of such organisms within homes and commercial structures.

The general consensus is that four factors have led to the elevation of mold as a major problem. The first involves new construction methods instituted in the 1970s to make buildings and homes more energy efficient. Tight sealing and heavy insulation significantly reduce a structure’s ability to “breathe,” thereby allowing moisture to be trapped within. Wherever moisture is a problem, mold has the means to grow and spread.

Second, the possible health implications of mold have many people in a panic. Intense debate exists in the medical community as to whether mold can cause serious health problems. There are thousands of species of mold, and most are not harmful. What seems to be fairly clear is that certain types of mold can cause allergic reactions in

some people, and asthma sufferers in particular can experience an increase in frequency and severity of attacks. According to the Centers for Disease Control (CDC), no official health standards currently exist regarding unacceptable levels of indoor mold. Furthermore, individuals have different sensitivities to mold, making it especially difficult to set standards and guidelines for indoor mold exposure levels.

A third factor is the legal climate, particularly high-impact lawsuits that tend to stimulate the adrenaline of lawyers and news reporters. The well-known Texas case of *Ballard v. Farmers Insurance Exchange*, which resulted in a \$32 million award to the plaintiff, got our attention quickly and signaled an impending crisis. Interestingly, the largest portion of this award, which involved a claim under a homeowners policy, was attributed to improper

claim handling and neglect on the part of the insurer rather than to the actual damage caused by mold. As a result, most company claim departments have changed the way they handle water damage claims involving even a slight chance that mold damage will result. These claims are now handled either by special claim units or by home office claim managers, with oversight by top claim executives.

The plaintiff in this case, Melinda Ballard, did not necessarily take the money and run. She, along with others, created a consumer advocacy group called Policyholders of America (POA), which recommended the creation of a government mold claim pool to be set up much like the National Flood Insurance Program. There is now a proposal before the House of Representatives, H.R. 5040, to accomplish this goal.

Although Texas and California account for the majority of U.S. mold claims, these claims are not confined to particular regions of the country; in fact, claims have been reported in virtually every state, with Florida, Arizona, Nevada, Illinois, and Pennsylvania also seeing significant claim activity. Understandably, commercial claims—those involving school, apartment, and office buildings—are the

most expensive to handle. Because all mold claims must be carefully and comprehensively investigated, often requiring testing for mold contamination, a plan for remediation, and substantial litigation costs, these claims have a huge allocated loss adjustment expense (ALAE) component. Insurers also need to be alert to fraud and abuse by policyholders and remediators, the latter not always being qualified to do the work, or calling for unnecessary work.

The fourth factor is media attention. Excuse the pun, but the media can “mold” public opinion and give high-profile coverage to almost any issue they choose. The media seem to be intensely aroused by mold and its quite questionable ramifications. We’ve seen headlines such as “We’ve Got Killer Mold,” “Haunted by Mold,” “Beware Toxic Mold,” and so on.

According to an Illinois reporter, “The mold situation is a complex tangle of reputable research, junk science, and panic.”

In a recent *National Underwriter* editorial, the editor implied that the situation just feeds on itself and grows. Increasing news coverage prompts more homeowners and business owners to check for mold, and to file claims if they find anything suspicious. And celebrity sufferers like Erin Brockovich and Ed McMahon, whose dog allegedly died from mold contamination, give the issue even more visibility.

Why are coverage changes needed?

Although coverage already exists in standard insurance policies to pay for some mold claims (those caused by a covered peril such as water damage or windstorm), the industry believed that steps had to be taken to control the exposure. In Texas, where the mold issue reached crisis proportions, the number of mold claims increased 548% between 2000 and 2001, and incurred losses and ALAE increased 755%, according to the Insurance Information Institute. Several insurers withdrew from the state in reaction to the mold claim explosion. And, as noted in the beginning of the article, homeowners mold claims across the country exceeded \$1 billion in 2001.

In response, insurers and insurance advisory organizations, such as AAIS and ISO, developed limited coverage buy-back options for mold. AAIS has developed a mold exclusion as well as a limited buy-back option for its affiliates.

In the personal lines area, AAIS developed advisory endorsements with several options: a complete exclusion for losses arising from “wet and dry rot, bacteria, fungi, or protists,” categories that encompass mold and other living organisms; an endorsement granting limited coverage for these losses that arise from any peril; and an endorsement granting limited coverage for losses arising only from accidental discharge of liquids or steam from plumbing, heating, A/C systems, etc. For detailed information about these endorsements and the mold issue in general, go to the AAIS Web site at www.aaisonline.com, and click on “Mold: where is the exposure?”

Some insurance departments have questioned insurers as to why they do not give rate credits in view of the fact that they are now restricting a coverage that was previously provided with no limit other than the policy limit. The reasoning is that current pricing does not reflect the mold exposures companies face today, in view of the dramatic claims increase that was unanticipated in the current pricing structure. Rates are based on past losses, and the recent increase in the frequency and severity of mold claims has not yet found its way statistically into the database available for rate-making purposes. So it seems premature to talk about adjusting rates at this time. Furthermore, there is a time lag in gathering and reporting statistics to regulators. Once this loss experience is reflected in the database and coverage limitations are taken into consideration, appropriate rate adjustments likely will be made.

Commercial liability endorsements

AAIS has filed three types of optional commercial liability endorsements relating to mold: (1) a general exclusion; (2) an exclusion for contracting operations; and (3) a limited coverage endorsement. These endorsements also address wet and dry rot, bacteria, fungi, and protists.

The general exclusion eliminates coverage for injury or damage arising from direct contact with or ingestion or inhalation of mold and other listed organisms, and chemical compounds/toxins released by them. It also excludes cleanup costs or costs for testing or due to claims by government authorities. Exceptions to the exclusions (there is coverage) apply to injury that results from fungi grown for human consumption (e.g., mushrooms), and from food poisoning. Another exception

preserves coverage for injury to a farm employee that arises from mold (e.g., moldy hay), to the extent that such coverage is provided in the underlying policy.

The exclusion for contracting operations applies only to damage or injury that arises out of the insured’s work or is included in the products/completed work hazard. Finally, the limited coverage endorsement covers mold damage up to separate per-occurrence and aggregate sub-limits. Exceptions are included for food poisoning and for fungi grown for human consumption, thus preserving coverage up to the full policy limits for such losses.

Construction defects and mold

Mold-related claims are often linked to claims of construction defects. Damage caused by construction defects has long been regarded as a business risk, and thus not insurable. However, a surge in claims alleging property damage from construction defects began in California in the 1980s and spread to other states. Buildups of mold can result from defects in construction, and the uproar over toxic mold makes it easier for plaintiffs to allege bodily injury.

Two main issues tend to exacerbate claim and lawsuit activity in this area. The first involves the exception to the “damage to your work” exclusion in commercial liability policies for subcontracted work. Many insurance practitioners believe that the exception to the exclusion is being exploited to make insurers assume business risks, and the industry is moving to eliminate the exception. If a subcontractor of the insured causes the damage, the exclusion does not apply.

The second issue involves “exterior insulation and finishing systems” (EIFS), commonly known as synthetic stucco. Synthetic stucco can trap moisture within the framing of the building or dwelling and cause mold buildup. Insurers are moving to exclude losses arising from installation of synthetic stucco.

AAIS’s response to construction defects was to develop and file three optional endorsements concurrently with its mold endorsements. One endorsement eliminates the exception for work done by subcontractors in general. A second endorsement eliminates the exception for work done by subcontractors at specific locations and for designated projects, and a third endorsement excludes

coverage for damage arising from EIFS. For details, go to the AAIS Web site at www.aaisonline.com.

Reason for hope

The industry is still in the process of putting in place exclusions and limited buy-back coverage options for mold and construction defect claims. This is considered necessary in view of the surge in claim frequency and severity. Not every state has approved mold exclusions and limitations.

The last two years have been particularly difficult for insurers, but there is some hope among insurers that we may have seen the worst with regard to mold claims. Time will tell whether that hope is real or simply wishful thinking.

For more information about AAIS insurance programs, contact Joyce Tignino, Vice President Marketing and Industry Relations, by phone at (800) 564-AAIS (2247), Ext. 236, or by e-mail (joycet@aaisonline.com).■

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