# INSURER CLAIMS HANDLING ISSUES IN MOLD LITIGATION

Mealey's Asbestos & Mold Insurance Conference
The Ritz-Carlton Hotel, Philadelphia
March 14-15, 2002
The Ritz-Carlton Hotel, Marina del Rey (Los Angeles)
April 18-19, 2002

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# *OUTLINE OF INSURER CLAIMS HANDLING ISSUES IN MOLD LITIGATION*

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## *I. First-Party Insurance Cases:*

1. First-Party Claims: Claims by the insured against the insurer under coverages for the insured's direct benefit, e.g. property claims.

2. First-Party Causes of Action:

   A. Breach of Contract.

   B. Extracontractual/Tort: Bad faith, fraud, negligent misrepresentation, intentional or negligent infliction of emotional distress, intentional interference with economic advantage and other torts in connection with settlement or investigation of a claim. Cal. Code of Regulations, 10 C.C.R. § 2695.7.[2]

      (1) A prerequisite for a bad faith claim is the insurer's breach of contract, *e.g.*, the failure to receive the benefits due under the policy. *Waller v. Truck Insurance Exchange*, 11 Cal.4th 1, 36 (1995).

3. First-Party Bad Faith Claims: Implied covenant of good faith and fair dealing enjoins the insurer from impairing the insured's right to receive the benefits under the contract. *Egan v. Mutual of Omaha Ins. Co.*, 24 Cal.3d 809, 818-819 (1979). An insurer is liable for "bad faith" in a first party policy context and is therefore subject to tort liability when an insurer "unreasonably withholds" contract benefits. *Gruenberg v. Aetna Ins. Co.*, 9 Cal. 566, 574 (1973); *Egan v. Mutual of Omaha Ins. Co.*, 24 Cal.3d 809, 818-819 (1973).

   A. Failure to thoroughly investigate: Denial of payments resulting from a failure to thoroughly investigate the claim may breach the implied covenant of good faith and fair dealing. *Egan*, 24 Cal.3d 809; Cal. Ins. Code §

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[2]The citations herein to supporting authorities focus on California law.

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790.3(h) (requires insurers to "adopt and implement reasonable standards for the prompt investigation of claims."); *Shade Foods, Inc. v. Innovative Products Sales & Marketing, Inc.*, 78 Cal. App. 4th 847, 879 (2000) (adequacy of an investigation is "[a]mong the most critical factors bearing on an insurer's good faith.").

(1) Adjusters must be knowledgeable. Persons handling a claim must be knowledgeable about molds and have a basic working understanding of the health risks posed by them. They must also have a working understanding of how mold contamination arises and what kinds of expertise must be brought in to identify and, if necessary, eradicate the mold. *See* American Institute for Chartered Property Casualty Unlimited ("AICPCU") Code of Professional Ethics ("Canon 2 - CPCUs should seek continually to maintain and improve their professional knowledge, skills and competence."); Society of Claims Law Associate ("SCLA") Code of Ethics ("Members of the Society shall remain current on the laws and regulations affecting their professional responsibilities by attending such classes, seminars and training as necessary.").

(2) Hire competent experts/professionals. Expert assistance may be necessary to determine the scope of damage and identify the potential health risks. A reasonable investigation requires the hiring of skilled professionals, *e.g.* microbiologists, who can quickly identify what kind of mold is present and whether a dangerous or potentially dangerous situation is present.

(3) Follow up and search for mold if "indicia" of mold contamination are present, *e.g.* where the adjustor is aware of a water damage loss and also knows that tenants or other occupants of a building are experiencing health problems. Failure to promptly and adequately remediate water claims can result in the growth or spreading of potentially toxic mold.

B. Failure to adequately remediate: In *Ballard v. Fire Ins. Exchange*, Ballard alleged that despite repeated warnings about dangerous mold, the Farmers' adjuster refused to pay for removal of the floor. Finding that, among other things, Farmers engaged in both unfair or deceptive acts or practices and unconscionable actions which caused damages, the jury awarded $12 million in punitive damages.

(1) No federal standards exist setting acceptable levels of exposure to mold.

(2) California standards: The Toxic Mold Protection Act, Cal. Health & Safety Code § 26100 et seq., states that the State Department of Health Services shall adopt permissible exposure limits to mold in indoor environments, and shall develop mold identification and remediation standards.[3]

C. Denial Based on Improper Standards. An insurer's denial of a claim based upon a standard that the insurer knows to be impermissible or on an interpretation contrary to established law may subject the insurer to extracontractual liability. *Moore v. American United Life Ins. Co.*, 150 Cal. App. 3d 610 621 (1984).

(1) The efficient proximate cause standard applies to mold claims in California. For an exclusion to apply under California law in a first party property policy, the "efficient proximate cause" of the loss must fall within the terms of the exclusion. *Garvey v. State Farm Fire & Casualty*, 48 Cal.3d 395 (1985). Although there are no California appellate cases addressing this precise issue, California courts would presumably hold that coverage for the cost of mold abatement may result where mold growth is caused by a covered cause of loss which is determined to be the efficient proximate cause of the entire loss, although an excluded peril such as mold may appear in the chain of causation. *See Stamm Theatres, Inc. v. Hartford Cas. Ins. Co.*, 93 Cal. App. 4th 531, 542 (2001) (coverage for "hidden decay" under an all-risk first party property insurance policy depended upon whether a covered risk was the "efficient proximate cause" of the loss); *Bethany Bowers v. Farmers Ins. Exchange*, Case No. 18306-8-III (slip op.)(Wash. Ct. App. 2000) (applying efficient proximate cause standard to mold infestation claim).

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[3] Note that Cal. Health & Safety Code § 26140 requires sellers or transferors of commercial real property to "provide written disclosure to prospective buyers as soon as practicable...of the presence of mold, both visible and invisible or hidden, that affects the unit or building..." Cal. Health & Safety Code §§ 26141, 26146 and 26147 likewise require commercial and industrial landlords, public entities that own, lease or operate commercial buildings and residential landlords to "provide written disclosure to prospective and current tenants of the affected units" when they know or have reasonable cause to believe that mold is present affecting the building. However, the above disclosures are not required until "the first January 1 or July 1" occurring after adoption of the standards and guidelines pursuant to Sections 26103, 26105 and 26130.

(2) Reliance upon exclusions which are void for public policy reasons. *Palub v. Hartford Underwriters Insurance Company*, 92 Cal. App. 4th 645 (2001) ("To the extent that the "exclusion" would exclude loss proximately caused by weather conditions, it violates Insurance Code section 530 and the long-standing principle that a property insurer is liable whenever a covered risk is the proximate cause of a loss, and is unenforceable.").

(3) Improper application of first party property damage triggers as a basis for denying coverage. Under California law, the trigger of coverage for a property policy is when the damage or loss, i.e. water damage or mold, manifests, not when the problem which led to the damage first became apparent. *Prudential-LMI Com. Insurance v. Superior Court*, 51 Cal.3d 674 (1990).

(4) Ensuing loss:

a. Claims personnel must reasonably consider whether the policy provides coverage for ensuing losses and whether the mold contamination is the result of such a covered ensuing loss.

b. For example, poor workmanship in installing plumbing or defects in the plumbing itself often is a non-covered peril. However, many policies cover ensuring loss from "water damage," which is defined to include water leaking from cracks or breaks in the plumbing system.

c. Because the resulting mold contamination is caused by a covered ensuing loss -- the leaking pipes -- the mold contamination may therefore also be covered.

D. Unreasonable delay in payment or processing of a claim may be evidence of bad faith. *Fleming v. Safeco Ins. Co.*, 160 Cal. App. 3d 31, 37 (1984).

(1) Where an insured has tendered both undisputed and disputed claims, the insurer should promptly pay the undisputed claims.

(2) Failure to promptly and adequately remediate water claims can result in the growth or spreading of potentially toxic mold. For example, failure to replace water-damaged wood with new dry wood, or to dry out moist wood, could result in mold contamination.

(3) Payment of additional living expenses for relocated insureds.

E. Inadequate communication with insured. *Delgado v. Heritage Life Ins. Co.*, 157 Cal. App. 3d 262, 278 (1984).

F. Cal. Code of Regulations, 10 C.C.R. § 2695.7 prohibits settlement of a claim "by making a settlement offer that is unreasonably low," *e.g.* by making an unreasonably low offer regarding the costs of repairing water damage.

4. Do insurance adjusters have a duty to warn the insured of the potential dangers of mold?

A. Unfair Claims Practices: Cal. Ins. Code § 790.03(h)(1) prohibits "misrepresenting to claimants pertinent facts or insurance policy provisions relating to any coverages at issue."

B. *Ballard v. Fire Ins. Exchange*, No. 99-05252 (Texas Dist., Travis Co.) Jury awarded the insureds $32.1 million, which included $12 million in punitive damages.

C. *Anderson v. Allstate*, No. CIV-00-907 (E.D. Cal.): A federal jury in Sacramento returned a verdict of $18.5 million, which included $18 million in punitive damages. The Ninth Circuit U.S. Court of Appeals heard oral arguments on appeal on November 5, 2001.

D. Professional and Ethical considerations: Adjusters with knowledge of mold and its dangers are ethically and professionally obligated to advise of the mold contamination. AICPCU Code of Prof. Ethics ("Canon 1 - CPCUs should endeavor at all times to place the public interest above their own," and "Canon 3 - CPCUs should obey all laws and regulations, and should avoid any conduct or activity which would cause unjust harm to others."); SCLA Code of Ethics ("SCLA") ("Members of the Society shall adhere to the highest standards in their dealings with the public and other professionals both within and outside of the industry. This includes, but is not limited to, claim professionals, physicians, attorneys, insureds, claimants and experts.").

5. Do insurers have potential direct liability to third parties who become sick or ill as a result of the insurer's failure to disclose the presence or suspected presence of mold contamination?

A. No probable bad faith liability because no contractual privity.

B. Negligence liability: Duty to undertake and authorize proper repair work in order to protect the public from the health risks associated with mold

contamination.[4]

6. Do attorneys retained by an insurance company to investigate a first-party loss have a duty to disclose the presence of mold contamination where disclosure could create liability for the insurer?

   A. Duty to maintain client confidences:

      (1) ABA Model Rule 1.6(a): The duty to protect client confidences includes all information relating to client representation, regardless of its source.

      (2) Under Business and Professions Code § 6068(e), an attorney has a statutory duty to "maintain inviolate the confidence, and at every peril to himself or herself to preserve" client secrets.

   B. Evidence Code § 956.5: the attorney-client privilege does not apply where the attorney reasonably believes that disclosure of a client's confidential communication is "necessary to prevent the client from committing a criminal act likely to result in death or substantial bodily harm."

   C. California Rules of Professional Conduct 5-220: An attorney "shall not suppress any evidence that the attorney or the attorney's client has a legal obligation to reveal or to produce."

7. Criminal liability: In *Ballard v. Fire Ins. Exchange*, criminal charges of child endangerment where brought against insurance company personnel. A criminal grand jury investigation followed, which may result in an indictment.

## *II. Third -Party Insurance Cases:*

1. Duty to Defend Generally:

   A. Insurer's options upon tender of a claim:

      (1) Defend the claim without raising any objections to coverage.

      (2) Defend the claim under a reservation of rights.

         a. Issues raised by remediation of mold contamination under a

[4] *See also* footnote no. 3.

reservation of rights:[5]

i. Because of the potentially significant public health risks to both insureds and third parties arising from mold contamination, does an insurer have a heightened obligation to fund remediation of mold contamination, even where legitimate coverage questions may exist?

ii. Is failure to offer to remediate under a reservation of rights to seek reimbursement bad faith?

b. When a third-party liability claim is tendered to an insurer, a conflict of interest may arise when the insurer defends a claim pursuant to a reservation of rights. Cal. Civil Code § 2860.

i. Under Civil Code § 2860(b), independent counsel may be required "where an insurer reserves its rights on a given issue and the outcome of that coverage issue can be controlled by counsel first retained by the insurer for the defense of the claim."

ii. Under Civil Code §2860(c), the insurer is obligated to pay "the rates which are actually paid by the insurer to attorneys retained by it in the ordinary course of business in the defense of similar actions in the community where the claim arose or is being defended."

iii. However, where there are no comparable cases, the usual insurer attorneys fee rates may not apply:

(A) Case involves new areas of law: Mold litigation is still relatively new. Insurers might not be able to limit the rates paid to typical insurer rates if there are no comparable "similar actions in the community."

(B) The insured's liabilities are great: If a large scale mold litigation matter involves a

[5] These issues also arise in the first party context.

potential liability which may result in the company's bankruptcy, an insurer might not be able to limit the attorney rates and fees because this type of case would not be "typical."

(3) Deny a defense, risking bad faith exposure if the denial was unreasonable. Cal. Civ. Code § 3333; *Shade Foods*, 78 Cal.4th at 879 (2000).

B. When is the existence of the duty to defend determined? An insurer's duty to defend "turns upon those facts known by the insurer at the inception of the third party lawsuit." *Montrose Chem. Corp. v. Sup. Ct.*, 6 Cal.4th 287, 295 (1993).

C. An insurer owes a duty to defend claims *potentially* covered by the policy. *Gray v. Zurich Ins. Co.*, 65 Cal.2d 263, 275 (1966); *Montrose*, 6 Cal.4th at 295. The potential for coverage is determined by the facts alleged. *Gray*, 65 Cal.2d at 276. The duty to defend includes groundless, false and fraudulent claims. *Horace Mann Ins. Co. v. Barbara B.*, 4 Cal.4th 1076, 1088 (1993).

D. Any uncertainty as to whether the insurer owes a duty to defend is resolved in favor of the insured. *B&E Convalescent Center v. State Compensation Ins. Fund*, 8 Cal. App. 4th 78, 99-100 (1992).

2. Scope of the Duty to Defend:

A. An insurer has a duty to defend the entire action if any claim is potentially covered. *Buss v. Sup. Ct.*, 16 Cal.4th 35, 48 (1997).

B. An insurer has a duty to provide competent defense counsel. *Merrit v. Reserve Ins. Co.*, 34 Cal. App. 3d 858, 882 (1973).

C. An insurer has a duty to adequately fund the insured's defense to sufficiently cover discovery costs, expert witness fees, etc. *Aerojet-General Corp. v. Transport Indem. Co.*, 17 Cal.4th 38, 58 (1997). The failure to properly fund a defense can constitute bad faith. *Id.*

(1) Defending mold claims is expensive because the cases are expert-intensive with respect to both liability and damage issues.

(2) "Investigation costs" incurred for purposes of minimizing liability may constitute a defense obligation. *Aerojet*, 17 Cal.4th 38. These

costs should be authorized and paid by the insurer.

(3) Expert Mold Testimony: Appropriate experts must be retained in mold contamination cases requiring specialized knowledge.

a. Bodily injury or property damage cases: Industrial hygienist testimony may be necessary to establish or controvert the presence of mold in sufficient quantities to cause the alleged injury. Medical experts are necessary to establish or controvert that the claimant's injuries resulted from mold exposure:

i. There are no definitive biological markers which establish mold exposure;

ii. The symptoms associated with mold are also attributable to many other causes;

iii. The neurological effects of mold exposure are still relatively unknown.

b. Property damage cases: Construction experts may be necessary to establish or controvert a defect, and to determine the remediation cost.

3. Third-Party Bad Faith Claims: Extracontractual liability attaches when the insurer engages in unreasonable conduct constituting a breach of its implied covenant of good faith and fair dealing.

A. An insurer's right to control the defense of third party claims is limited by the covenant of good faith and fair dealing. *Waller v. Truck Ins. Exch., Inc*., 11 Cal.4th 1, 36 (1995).

B. An insurer's right to control settlement of third party claims against the insured is also limited by the covenant of good faith and fair dealing. *Id.*

C. The policy limits do not limit damages recoverable against an insurer for breach of the covenant of good faith and fair dealing. *Comunale v. Traders & Gen. Ins. Co.*, 50 Cal.2d 654, 661 (1958).

D. Extracontractual liability may also exist against an insurer without bad faith if it refuses to settle based upon its coverage position. If coverage exists, the insurer is liable for all damages awarded in excess of policy limits, even if its coverage position was reasonable. *Johansen v. California State*

*Auto Ass'n Inter-Ins. Bureau*, 15 Cal.3d 9 (1975); *Samson v. Transamerica Ins. Co.*, 30 Cal.3d 220 (1981).

4. Consequential damages flowing from bad faith claims handling of mold claims:

   A. Bad faith claims handling is generally considered tortious conduct and the insured is entitled to recover all resulting damages whether or not they were foreseeable. *See e.g. Silberg v. California Life Ins. Co.*, 11 Cal.3d 452, 462 (1974).

   B. Costs of defending and paying any settlements or awards from lawsuits brought against an insured by tenants or other occupants of a building may be consequential damages of the insurer's bad faith.

5. Notice Issues:

   A. Insureds should tender for each policy period in which the mold was growing because a continuous injury trigger probably applies. For property damage claims, the continuous injury trigger would start from the time when the wood (or other cellulose-containing material) first became wet through the time when the property damage was found or manifested itself. For bodily injury claims, give notice from first exposure through the time of the claim.

   B. Insureds should tender claims promptly, ensuring that umbrella and excess carriers are given early notice. This is important in situations where liability could exceed lower limits, and is also important because the umbrella policies and the excess policies which follow form to the umbrella policies often contain broader coverage.

   C. For example, a claim seeking damages for emotional distress and mental anguish because of "exposure" to toxic mold might not be covered under a primary policy defining bodily injury as "bodily injury, sickness or disease." However, the "drop down" coverage under an umbrella policy may be triggered for such a claim because the umbrella policy contains a definition of bodily injury including coverage for emotional distress and mental anguish.