

**COZEN AND O'CONNOR
TECHNICAL HANDBOOK**

MOLDING THE SUBROGATION CLAIM FOR MOLD DAMAGE

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I. INTRODUCTION

Up to this point, mold litigation has focused almost exclusively on first party coverage claims between insureds and insurance companies. There have been several high-profile cases where underwriters have been forced to pay building owners millions of dollars to remediate problems caused by mold and other sick building maladies. The potential exposure for insurance companies may run into the *billions* of dollars. Your companies' top management will be looking to their in-house subrogation professionals and outside recovery counsel with one question: How do we recover these claim payments back from the truly responsible third parties who carelessly caused the conditions that created the mold? The purpose of this paper is to alert claims professionals about the recovery opportunities arising out of mold claims.

II. MOLD - DEFINED

Mold is the term used to describe the unsightly furry fungi you see growing in the most undesirable places. There is actually no single type of mold, but rather thousands of different varieties. There are molds that are benign, and molds that are toxic. In fact, there are over one hundred mold species that can cause infections in humans.

To grow, mold requires moisture, a food source, and a relatively warm temperature. In a building, the moisture can come from any number of sources, including leaks in the roofing system, cracks or gaps in the windows and doors, a defective HVAC system, or improper humidity control. Mold uses cellulose fibers found in the building's own materials as a food source to foster its growth, including insulation, carpets, acoustical ceiling tiles, wall coverings, carpets, and even upholstered furniture. This process often results in significant damage to the affected materials.

In addition, many molds produce toxic chemicals known as mycotoxins. If these mycotoxins grow in or near a building's air handling system, they can be circulated--and recirculated--throughout the entire building many times in a single day. This can cause significant health problems for the building's occupants, including dry cough, breathlessness, bronchial asthma, chest tightness, eye irritation, sore throats, asthma and, in its most severe case, even death. Mold recently was blamed for the deaths of seven infants in Cleveland.

Because mold grows in a building's most hidden recesses, finding it can be hard. Sometimes it requires good old-fashioned detective work. The signs of potential mold range from the obvious--a musty odor--to the more subtle--complaints by workers of health problems, such as coughing and itchy eyes, that disappear once the workers leave the building.

Once discovered, microbial contamination must be removed. Remediation can range from something as simple as cleaning the affected area with bleach and a rag, to calling in professionals in decontamination suits for a full-scale detoxification, as in the case of asbestos abatement. Remediation can cost anywhere from a few hundred dollars, to tens of *millions* of dollars.

III. POTENTIAL SUBROGATION CLAIMS ARISING FROM MOLD LOSSES

A. CONSTRUCTION DEFECT CASES

There is a large class of construction specialists who may be held liable in a subrogation action founded on mold damage. Obviously, the job of a construction manager is to oversee the construction to make sure that the building is erected properly. It is the construction manager's job to inspect each subcontractor's work to make sure that it is done properly and in conformity with the project drawings and specifications. Thus, it is reasonable to argue that careful construction management will disclose the types of problems that give rise to moisture penetration (i.e., improper roof flashing, inadequate window seals) during the construction process, thereby making sure that such problems can be remedied before the construction is completed. Thus, in any construction defect subrogation case, the construction manager's responsibility must be scrutinized.

In addition to the construction manager, there are numerous other entities involved in a building's initial construction who may bear some responsibility for construction defects that give rise to mold growth. They include:

a) Project architect - Sometimes project architects also retain supervisory and inspection duties with respect to a construction project. To the extent they do so, they may be liable to the same extent as the construction manager. In addition, an architect may be subject to liability where the mold growth condition is caused by the faulty design of the building, such as where the design increased the likelihood of water ponding on the roof. The architect may also be at fault for specifying the use of certain construction materials, such as the EIFS discussed elsewhere in this paper, or where he or she specifies faulty construction techniques.

b) Mechanical engineer - Usually a mechanical engineer is retained to design the building's HVAC system. In designing the system, the mechanical engineer must take into account the humidity and other environmental conditions of the locale where the building is being constructed. In order to maintain an appropriate balance of fresh air, a more humid climate may require less outside air being introduced into the building by the HVAC system. An improperly designed HVAC system may result in a building being too humid, thereby creating an environment ripe for mold growth.

c) Subcontractors - Subcontractors who perform substandard work are, of course, potentially liable if their erection errors caused conditions which allowed mold to develop. For instance, a window subcontractor may be liable for failing to properly install and caulk windows; or a roofing subcontractor may be at fault for failing to properly install a water-tight roof.

d) Product manufacturers - Manufacturers of prefabricated building materials may also bear responsibility for causing mold growth conditions. One obvious example would be the manufacturers of window and door encasements. If not properly manufactured, these items will not be water-tight, thereby allowing moisture to enter the building and create an environment favoring mold growth. Another example is the manufacturer of a roofing membrane that leaks.

The manufacturers of a product known as Exterior Insulation and Finish System (EIFS) have recently become a favorite target of product liability suits in Sick Building Syndrome cases. EIFS is a synthetic stucco system that is applied to the exterior surfaces of buildings. It features a mixture of specialty materials which are troweled onto the exterior surface of a building, and allowed to harden into a tough shell. According to manufacturers, the product is not only cost-effective and aesthetically pleasing, but it also serves as an excellent insulation material.

However, as one commentator noted, one of the product's purported benefits may also be its Achilles heel: "[The product] is so waterproof that not only can water not penetrate its surface from the outside, but also water that manages to penetrate its surface cannot escape." As a result, water gets trapped behind the EIFS, thereby creating a moist environment which rots wood, destroys wallboard and other building components, and enables mold to sprout and flourish.

More than a thousand lawsuits have been filed against the manufacturers of EIFS. The complaints allege two theories of liability: first, that the product is defectively designed because it entraps water rather than allowing it to escape; and second, that the manufacturers knew about this tendency to entrap water, but did nothing to warn builders and property owners of the problem. The manufacturers, on the other hand, maintain that there is nothing wrong with the product itself. Instead, they argue that any problems associated with the product are caused by shoddy workmanship by EIFS applicators in installing the EIFS system.

Several state legislatures have stepped into the fray, weighing in decidedly on the side of consumers. Georgia and North Carolina have enacted statutes limiting, or even banning the use of EIFS on residential structures. In addition, Georgia has incorporated a discovery rule into its statute of limitations for property damage caused by synthetic siding. This move was deemed necessary because it was clear that many homeowners were not discovering the damage caused to their homes by the EIFS product until after the applicable statute of limitations had already expired.

Most of the lawsuits filed thus far against EIFS manufacturers have involved residential homes.¹ However, it is believed that future litigation will focus on commercial structures. This is largely because EIFS was actually a far more popular cladding system for commercial structures than it was for residential buildings. In fact, one commentator has observed, “The number of hotels, restaurants, banks, shopping malls, and strip malls that have been, and continue to be, constructed with EIFS is simply staggering.”² And since the cost of remediating a commercial structure will be substantially higher than remediating a residential structure, this may to be a fertile area for subrogation claims.

B. LANDLORD/TENANT CASES

The landlord/tenant relationship also may give rise to subrogation claims involving damage by mold. For instance, the tenants of an apartment complex in Delaware received a million dollar verdict in their lawsuit against the landlord for physical injuries caused by mold exposure. And in Baltimore, three county employees recently filed a \$3 million dollar lawsuit against building owners and managers for medical ailments they allegedly sustained as a result of the defendants’ failure to replace the building’s HVAC system as was required in the lease. While these lawsuits involve claims for physical injuries, it is logical to extend these theories of liability to property damage and time element losses due to mold growth caused by the negligence of the owner or occupant of commercial or residential properties.

¹ Many of the lawsuits have been settled by the EIFS manufacturers. As of the summer of 2000, only five cases had actually proceeded to trial, with the results being a mixed bag.

² Epstein, note 4 at 15.

A landlord's potential liability must be analyzed in any case where the insured is a tenant whose building is closed due to a mold growth incident. The lease must be reviewed to see if there is any obligation on the landlord to maintain the instrumentality that caused the mold incident. For instance, if the mold growth was caused by a problem with the HVAC system--i.e., due to a problem with the drip pan or the cooling tower--and the landlord has assumed responsibility under the lease for maintaining the HVAC system, then the landlord may be held liable under a breach of contract theory.

While attention has been focused on the landlord's potential liability, tenant activity also may be the cause of a mold problem. Obviously, if the tenant is responsible for maintaining the HVAC system, he or she may be held liable if the HVAC system causes the mold growth problem. Moreover, if the mold growth is caused by some particular activity that the tenant conducts inside the building, the tenant may be held liable for the resulting damages. Finally, a tenant also may be found liable where a tenant's negligence causes a flooding condition inside the building that subsequently spawns a mold growth situation.

C. OTHER POTENTIALLY RESPONSIBLE PARTIES

While construction defect and landlord-tenant cases provide the greatest opportunities for subrogation recoveries in mold cases, there are other potential claims that the subrogation professional should recognize as affording a recovery opportunity:

a) HVAC maintenance contractors - Even if the original design of a building's HVAC system is proper, the system can be improperly maintained so as to create a mold growth situation. There are several ways in which an improperly maintained HVAC system can

introduce moisture into a building, thereby creating an environment conducive to mold growth. These include malfunctions or defects in drip pans, humidifiers, cooling towers and duct liners.

b) Water Extraction Companies - These companies are hired whenever there is a fire, a pipe break, a sewer backup, or other event which causes flooding inside a building. They must take great care in performing their work, or else moisture may be left behind in building materials, such as wallboard and insulation, thereby creating an environment conducive to mold growth. In 1994, industry experts convened to create a standard for the proper methods for water damage restoration. Their work produced a document called "The Standard and Reference Guide of Professional Water Damage Restoration." Yet, remarkably, authorities in the field claim that most abatement firms have never even read it!

c) Real Estate Transactions - Real estate transactions can give rise to potential claims against owners and/or real estate brokers who conceal or fail to disclose facts relating to water leaks and mold growth that they know about.³ Ordinarily, a seller or broker has no duty to disclose facts he or she does not know about, nor are they obligated to investigate potential defects that the buyer is just as capable of discovering through proper investigation. Thus, an owner or broker will only be liable for known defects that they fail to disclose.

Another issue arising out of a real estate transaction is the liability of professionals or contractors who inspected the premises prior to purchase and failed to discover the conditions creating mold propagation.

IV. CONCLUSION

Claims of mold damage, albeit complex and frequently the result of a confluence of multiple factors, bring with them favorable prospects for successful pursuit of subrogation claims. It is imperative, however, that your Company deploy appropriate resources, including early intervention by experienced and specialized subrogation counsel, to ensure that no recovery opportunities are overlooked, and that claims which are pursued are handled properly so as to enhance the ultimate recovery for your Company. For additional information concerning Cozen and O'Connor's Mold Recovery Program, please contact:

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³ See, e.g., Cregg v. Roman, 2000 W.L. 688264 (Tex. App.).