

AMERICAN RISK MANAGEMENT RESOURCES NETWORK, LLC

Lenders Tip Sheet

The Impact of Universal Mold Exclusions On Lenders And Practical Risk Management Solutions

Introduction

The introduction of mold/fungus/microbial exclusions in virtually all personal lines and commercial lines insurance policies over the past two years has created newly uninsured loss exposures for lenders on an unprecedented scale. This paper will put mold claims into perspective by comparing these relatively new claims to more familiar loss exposures. It will also project the economic impact of mold related insurance exclusions on different sectors of the economy and present a pragmatic approach to insuring mold related loss exposures on a prospective basis.

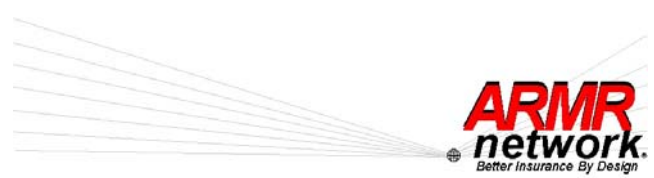
Insurance companies have successfully off loaded tens of billions of dollars of formerly insured mold related damage claims onto other sectors in the economy thru the introduction of hundreds of nonstandardized fungus/mold/microbial matter exclusions (mold exclusions) on property, liability and professional liability insurance policies. Lenders are likely to pick up slightly more than their fair share of these uninsured losses.

Because there are literally hundreds of different “mold exclusions” in use today, it is impossible to make global observations on how the exclusions will impact the insurance coverage on individual insurance buyers. However, there is one common denominator in all mold exclusions; they are essentially pollution exclusions for the specific pollutant mold/fungus/microbial matter. Pollution exclusions have the distinction of being the most litigated words in the history of the insurance industry. Over the past twenty years insurance companies and insurance buyers have won approximately half of the pollution coverage litigation cases, although this varies by state. There is very little case law regarding mold exclusions at this time. Although based on the past experience with pollution exclusions it is safe to predict there will be a claims handling morass as claims adjusters are asked to draw the line on excluded mold damages versus other covered damages in the policy. For lenders the uncertainty of coverage for mold losses increases the risk that has been forced upon them by the insurance companies.

There are basically three categories of mold exclusions in insurance policies today.

1. A total exclusion for all “mold related” damages.
2. A partial exclusion for subsequent damage caused by mold.
3. Full coverage for mold related damages if caused by a covered loss.

Outside of excluding mold damages outright, some insurance policies restrict the coverage monetarily. It is common today in personal lines insurance policies for insurance companies to either restrict coverage with a sub-limit for mold related damages or to offer a buy-back of mold damages coverage for an extra premium. The availability of coverage under these options varies widely by state and by



AMERICAN RISK MANAGEMENT RESOURCES NETWORK, LLC

insurance company. There are fewer buy-back or sub-limit options to buyers of commercial insurance than there are for personal lines policies.

Three basic strategies for lenders to obtain insurance on mold risks

Lenders can follow three basic strategies to obtain coverage for mold risks in their secured property portfolio.

1. Do nothing, which is the default mode most lenders are in today. This strategy leaves borrowers partially uninsured and lenders partially unsecured for mold related damages.
2. Actively evaluate the insurance coverage of borrowers and encourage the acquisition of prospective insurance with less restrictive mold exclusions.
3. Actively encourage borrowers to acquire appropriate insurance coverage for mold related damages.
- 4.

Because of the wide variation in mold exclusions, lenders trying to actively manage mold risks will find it more practical to request appropriate prospective coverage for mold related damages than to monitor and evaluate mold exclusions in their customer's insurance policies.

Today the lending community is in the default risk management mode for mold related claims. This could be a rational risk management strategy and the least cost alternative. Although it is unlikely anyone following this strategy actually evaluated the loss exposure prior to ending up with the approach.

The total uninsured mold related loss exposure to lenders is likely to be about two billion dollars annually. If this amount is evenly distributed across the entire lending community it will only have a small impact on earnings. However, mold losses are not evenly distributed. For example, Nevada has a mold loss frequency thirty times greater than Wisconsin. In Texas mold loss frequency is fifty times greater than Wisconsin. Mold already has the distinction of bankrupting more builders than any form of casualty loss in history and although the majority of mold claims are under \$5,000, there are multiple claims in excess of ten million dollars working their way through the court system. Still the default mode could be a rational risk management approach for lenders, it certainly has the advantage of having low implementation costs.

Losses arising out of the fire peril serve as a good benchmark to gauge the rational of retaining mold risks. In 2001-2002, before mold exclusions were in full effect, mold damage claims in the insurance industry were mirroring fire insurance claims. Both causes of loss had similar claims frequency and aggregate claims statistics. Therefore a rational risk manager that is comfortable retaining mold risks in their loan portfolio should be equally comfortable being unsecured or uninsured for losses caused by fires.

For the lending community, mold exclusions create a whole new set of uninsured loss exposures that were covered in standard insurance policies prior to the introduction of the new exclusions. These newly uninsured loss exposures are:

1. Property backed loan security that is not insured for mold related losses.
2. There is a greater insolvency risk for bank customers who are now uninsured for property and liability mold related losses.

AMERICAN RISK MANAGEMENT RESOURCES NETWORK, LLC

3. For lenders with insurance sales operations, there are unprecedented levels of professional liability exposure for their client's unintentionally uninsured mold related losses. The lender's insurance agents professional errors and omissions liability loss exposure is also likely to be uninsured due to an unprecedented "mold related claims" exclusion in many insurance agent's professional liability insurance policies.
4. Lenders will also have mold exclusions in their own property policies and properties held in trust. When left uninsured for mold damages, properties held in trust increase the lenders fiduciary liability exposure for uninsured mold losses. A lenders liability insurance portfolio is also likely to have mold related claims exclusions on each policy, therefore all liability loss exposures "related to" mold will also be retained by the lender.

How to insure against these newly uninsured loss exposures

Anyone who owns, rents, leases, maintains, builds, designs, buys or sells, has employees in, manufactures or sells products to, or works on a building that is occupied by humans, or lends money to anyone in the chain, has an exposure to uninsured mold related losses. These sectors represent most the US economy.

Anywhere a contract depends on an indemnity agreement backed up by an insurance policy, special attention should be paid to the effect of pollution/mold exclusions on the insurance policies backing the indemnity obligations. Solutions to insuring mold damages exist. However in the default mode, it is safe to assume there will be significant restrictions in the insurance coverage provided for mold caused damages in all personal lines or commercial insurance policies.

To insure mold damages on a prospective basis lenders need to evaluate their exposure to uninsured property claims and liability claims in their customer base and their own loss exposures to uninsured owned property, property held in trust and liability loss exposures and then create a strategy to address each exposure.

1. Damage to Property.

There are limited but expanding markets for mold coverage in personal and commercial property insurance policies. There is currently a healthy insurance market offering buy-backs and sub-limits for mold damages on homeowners insurance in most states. However insurance buyers will need to search for this coverage because not all insurance companies may offer it.

Commercial insurance buyers face a much more difficult mold insurance market for the equivalent of property insurance covering the first party clean up of mold related damages. Some coverage for on site clean up for mold damages is available in the environmental liability insurance market place. However, most of these environmental insurance policies require that the "clean up" be mandated by governmental authority in order to be a covered loss. Since there are no governmental clean up standards for mold, the first party on-site clean up coverage for mold damages could be illusionary in an off-the-shelf environmental liability insurance policy. However the environmental insurance market place is constantly adapting their products to meet the challenges and opportunity created by mold risks. Lenders seeking to obtain a secured position for mold damages on commercial customers will need to monitor

7507 Hubbard Ave., Suite 200 ~ Middleton, WI 53562 ~ 800-735-0800 ~ Fax: 608-836-9565

AMERICAN RISK MANAGEMENT RESOURCES NETWORK, LLC

the insurance market place for solutions. These solutions are under constant development by environmental insurance underwriters and there is some limited coverage for first party mold clean up available today. The commercial mold insurance market can be monitored on the front page of the website of the Environmental Risk Resources Association at <http://www.erraonline.org/>.

It is interesting to note that loan covenants requiring either “all risk” or “extended peril” property insurance have technically been breached if a property insurance policy with a separate exclusion for mold damages is provided by the borrower on the secured property. Lenders may be able to shift most of the expense of due diligence in obtaining appropriate insurance for mold damages onto their customers through the annual insurance certificate process on secured loans. If the request for compliant all risk property insurance without a mold exclusion was done in a positive and helpful manner by the lender in the certificate of insurance request, a significant part of the mold loss exposure could be transferred away from the lender at a very low cost. This practical and economical risk management strategy is being completely underutilized by lenders.

2. Liability Loss Exposure

To insure against liability related to mold damages, the environmental insurance market place is pioneering the tailoring of existing environmental insurance products to cover mold related damages for commercial buyers of insurance. This is accomplished by expanding the definition of covered “pollutants” in the environmental insurance policy to include mold and a list of other related materials. Most off-the-shelf definitions of “pollutants” in environmental insurance policies are ambiguous when it comes to defining coverage for mold related damages. Therefore it will be very important that the environmental insurance policy purchased to address mold related loss exposures specifically states in the insuring agreements that mold is a defined pollutant in the policy.

There are basically five types of environmental insurance designed to address the environmental liability loss exposures of commercial insurance buyers. These policy forms can be adapted to effectively insure against mold related liability damages.

- Environmental Impairment Liability Insurance or Pollution Legal Liability Insurance is designed to insure fixed locations. The “On Site Clean Up” coverage in these policies is essentially first party property insurance coverage. Environmental Impairment Liability Insurance policies can also be amended to cover products liability and are appropriate for building products manufacturers and suppliers.
- Contractors Pollution Liability or Contractors Environmental Impairment Liability is appropriate for any firm with operations that need to be insured. This would include general contractors, builders, roofers, plumbers, HVAC contractors, fire restoration contractors, building managers, fire sprinkler installers, ect.
- Professional Liability insurance for professional services firms. (Professional liability policies from traditional suppliers can have “mold related claims” exclusions)

AMERICAN RISK MANAGEMENT RESOURCES NETWORK, LLC

- Combined Policy Forms, Some firms will find purchasing environmental insurance in a package combining General Liability insurance with Contractors and Professional Environmental coverage more economical than purchasing these coverage's separately.
- Secured Creditors policies can address mold as a covered pollutant. However there is a fundamental disconnect between the long term nature of a secured creditor insurance policy and the short term ongoing maintenance issues related to mold losses. Therefore it is unlikely that secured creditors insurance will be widely available with coverage for mold damages.

There is a greater risk of insolvency from any borrower that has an exposure to liability for mold related damages, because these customers are almost certainly uninsured for this loss exposure. Mold related damages have already bankrupted a number of homebuilders of various sizes including builders with revenues measured in the hundreds of millions of dollars. Appropriate environmental insurance can be an effective tool in avoiding the bankruptcy of a borrower caused by toxic mold claims.

3. Insurance Agency Professional liability

Banks with insurance sales operations can implement a simple four-step process that will essentially make them bullet proof from mold related professional liability claims. The risk management strategy for insurance agency operations is detailed in the article, [A Risk Advisors Survival Guide to Mold Exclusions](http://www.erraonline.org/envclaims.html) <http://www.erraonline.org/envclaims.html>.

4. Lender Owned Property

For the lenders own property there is a very limited environmental insurance market available. On site clean up in an environmental impairment liability policy is one possible way to obtain first party clean up coverage for mold. However the insurance policy purchased may need to be amended to provide the coverage in a clear and concise manner.

Monitor insurance product innovations

The environmental insurance market place is constantly adapting to address the new need to insure mold damages on environmental insurance policy forms. An example of one such innovation is the development of a wrap up approach to mold insurance for new commercial buildings. Under this approach the risks of the developer and contractor are insured under a property transfer environmental insurance policy at the beginning of construction operations. Upon the sale of the building the owner is added to the policy as a named insured and assumes the deductible. To assure the proper ongoing maintenance of the building, the insurance underwriter provides mold loss control services over the ten-year policy term with out additional premium charges to the owner. The one time cost of this policy

AMERICAN RISK MANAGEMENT RESOURCES NETWORK, LLC

covering multiple named insured's is about \$1 per square foot for a \$10,000,000 policy limit that has a ten-year policy term. The one time premium includes the cost of specialized building science based loss control engineering over the course of the policy term. This insurance premium converts to one cent per square foot, per year, for each million dollars of insurance purchased. Expressed in this manner there would seem to be little justification for new commercial construction to be uninsured for mold related damages. This coverage is available in all fifty states on of all types of commercial construction exceeding fifty thousand square feet, from an insurance company with an A+ rating. Lenders can expect similar innovations in the future by the environmental insurance market.T

A Background on Mold Claims and Insurance Exclusions

A rapid increase in mold claims, followed by universal insurance exclusions for "mold related claims", will create hundreds of thousands of uninsured mold related losses in 2004 and beyond. An army of specialized plaintiffs lawyers will gravitate towards liability lawsuits to seek recovery of damages for their clients when a property insurance policy excludes the mold loss. Insurance to cover mold is available, but insurance agents are ignoring it. The result is unprecedented professional liability loss exposure for insurance agents and brokers, which has triggered a separate "mold related claims" exclusion in many insurance agent professional liability insurance policies. In anticipation of the claims morass, professional liability underwriters are adding "mold related claims" exclusions to claims adjusters professional E&O policies. There is no precedence in the insurance industry for this combination of events. Never before has the personal lines and commercial insurance market moved in unison to eliminate insurance coverage for a single cause of loss. Never before has the insurance industry had to deal with toxic tort claims with the on going loss frequency of water damage claims. Lenders have new loss exposures from multiple sources because of mold exclusions.

Primary Driving Factors of Mold Losses

- Changes in building materials and techniques
- An emphasis on energy efficient buildings
- New science linking mold to adverse health effects
- Lawyers attended hundreds of "mold is gold" seminars
- The press
- Tens of thousands of successful claims, for billions of dollars

Mold Claims In Perspective

In 2002 mold claims looked very much like fire insurance losses in the US. They had similar loss frequency and severity measures.

Because of an explosive growth in mold related damages claims, mold exclusions were quietly slipped into virtually all property, liability and professional liability insurance policies in 2003. One thing that was very unusual about the unilateral introduction of mold exclusions is that there was essentially no out-cry from insurance consumers at the time the exclusions were being introduced. This lack of concern was most likely because consumers had no way to gauge the ramifications of the new exclusions and concern over mold exclusions was over shadowed by concern over terrorism exclusions which were introduced at the same time. If the insurance industry had disclosed it was going to be

7507 Hubbard Ave., Suite 200 ~ Middleton, WI 53562 ~ 800-735-0800 ~ Fax: 608-836-9565

www.armr.net

AMERICAN RISK MANAGEMENT RESOURCES NETWORK, LLC

excluding the equivalent of all fire losses in the future, the reaction by insurance buyers would have been dramatically different than it has been for mold. The article entitled [New Insurance Exclusions for Terrorism and Mold Damages Create Unprecedented Uninsured Loss Exposures for Property Managers, Property Owners and Their Lenders, or Sorry We Forgot To Tell You...](http://www.erraonline.org/journalproperty.pdf) at <http://www.erraonline.org/journalproperty.pdf> presents a somewhat humorous view of what the underwriting community could have disclosed about mold and terrorism exclusions, but didn't. This article appeared in the Journal of Property Management in the Summer 2003 edition. With mold exclusions in virtually all insurance policies today the insurance industry has successfully shifted the equivalent loss content of fire claims back into the economy as uninsured mold losses. This shift of billions of dollars of mold related losses is certain to have some measurable impact on the lenders.

Where did all of these mold claims come from? Prior to the new science linking mold to adverse health affects in humans, prior to the lawyers and prior the media attention, mold claims were water damage claims without Bodily Injury and Defense costs. There are hundreds of thousands of water damage claims annually; these water damage/mold losses are not going away just because there are exclusions in insurance policies. One of the reasons there are more mold claims today is there is more water in buildings than we have had in the past and people are much more likely to fix a mold problem once it is identified. These underlying drivers virtually guarantee that mold losses will continue in the future.

Mold related claims exclusions on both homeowners and commercial insurance policies will shift a significant number of these newly uninsured losses to new sectors of the economy. The domino effect of an uninsured mold related loss is shown at:

<http://www.erraonline.org/domino.pdf>

Research conducted by American Risk Management Resources Network, LLC. predicts that mold loss frequency will likely level off at 30% of its peak level in 2002, while maintaining about 40% of the loss content in subsequent years.

There are mold claims in every state; however states with air-conditioned environments and significant amounts of new construction have the highest frequency of mold related damages. These high-risk areas include the desert states.

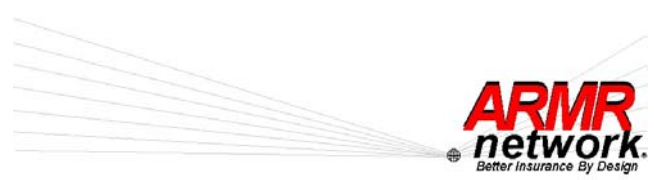
Mold risk overview

Further background on managing mold risks is provided on the website of the Environmental Risk Resources Association.

<http://www.erraonline.org/mold.htm>

Conclusion

The introduction of hundreds of different types of mold insurance exclusions has left lenders unsecured and uninsured for mold related losses. Although prospective insurance products are available to cover some or all of these loss exposures it, these insurance products are not being effectively utilized by the majority of lenders at this time. Without insurance to cushion the losses, lenders will absorbing part of the loss exposure that lead the insurance industry to universally exclude or restrict coverage for mold losses after incurring billions of dollars in losses in 2002.



AMERICAN RISK MANAGEMENT RESOURCES NETWORK, LLC

David J Dybdahl, CPCU, ARM is a senior consultant with American Risk Management Resources Network, LLC. He is a licensed surplus lines insurance broker and risk management consultant specializing in environmental risk management and insurance. He is internationally recognized for his expertise in environmental insurance. He is a frequent contributor to the Environmental Bankers Association and the Society of Chartered Property and Casualty Underwriters. The majority of the loss statistics for this article were generated by proprietary research and consulting projects for his clients. He can be reached at dybdahl@armr.net or 608 836 9590.