THE AFTERMATH OF *FIESS*--

ENSUING LOSS, MOLD & AMBIGUITIES

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I. INTRODUCTION

Though commonly found in every habitat since the biblical days, mold became a trend of claims in the insurance and legal industries. A flux of residential and commercial property claims involving mold damage, which may have been on the property long before it was purchased, created a new waive of litigation. However, the Texas Supreme Court recently ruled that mold damage to a residential dwelling is not covered under the Texas Homeowners Form B Policy (HO-B) in *Fiess v. State Farm Lloyds*, 202 S.W.3d 744 (Tex. 2006).

This article will address the Supreme Court's analysis of the mold exclusion, the ensuing loss exception and the Court's application of policy interpretation rules in Texas.

II. HISTORICAL ANALYSIS OF "ENSUING LOSS" BEFORE THE TEXAS JUDICIARY

Since the $32 million dollar verdict in *Mary Ballard, et al v. Fire Ins. Exchange, et al*, No. 99-05252, Travis County District Court, first party mold claims increased in number and notoriety.[1] The *Ballard* claim began as a single claim for water damage to a hardwood floor and evolved to include mold contamination of the entire house and outbuildings on the property.

Each mold claim involves an analysis of the mold exclusion found in the HOB policy form, which is approved by the Texas Department of Insurance and used in over 95% of the homeowners policies issued in Texas prior to January 2, 2003. The mold exclusion reads:

> We do not cover loss caused by:
> * * *
> (2) rust, rot, **mold** or other fungi,
> * * *
> We do cover ensuing loss caused by collapse of building or any part of the building, water damage, or breakage of glass which is part of the building if the loss would otherwise be covered under this policy.

This language has been interpreted in the past to provide coverage for the otherwise excluded damage caused by mold if it is an "ensuing loss" caused by water damage. There is no question that water and/or moisture are required for mold growth to occur. So it would appear that there would never be a question of coverage. Texas courts have rendered a progression of opinions to get to this conclusion until *Fiess.*

First, in 1965 the Fifth Circuit predicted Texas law in *Aetna Casualty and Surety Co. v. Yates*, 344 F.2d 939 (5th Cir. 1965) as to whether coverage was triggered under the Homeowners All Risk policy for structural damage to wooden joists, sills and subflooring caused by excessive moisture trapped in the crawl space of the insured's home. The policy in question contained an ensuing loss provision which the insured asserted gave rise to coverage despite a policy exclusion that expressly excluded

[1] The $32 million verdict was remitted on appeal to $4,006,320.72 in actual damages and no punitive or mental anguish damages. The court upheld the trial court's award of the article 21.55 statutory penalty, but remanded the penalty for recalculation to exclude amount of delay caused by insured. The court remanded the award of attorneys' fees for reasonableness in light of the significant reduction of the jury's damages. *See Allison v. Fire Insurance Exchange*, 98 S.W.3d 227 (Tex. App. – Austin, December 19, 2002). The case was ultimately settled and dismissed with prejudice on 4/14/04.

loss caused by "inherent vice, wear and tear, deterioration, rust, rot, mold or other fungi, dampness of atmosphere, extremes of temperature…." *Id.* at 940-941.

The Fifth Circuit held that the resulting rot and structural damage was expressly excluded under the policy. The court reasoned:

> We do not think that a single phenomenon that is clearly an excluded risk under the policy was meant to become compensable because in a philosophical sense it can also be classified as water damage; it would not be easy to find a case of rot or dampness of atmosphere not equally subject to that label and the exclusions would become practically meaning-less. In our case the rot may have ensued from water but not from water damage, and the damage ensuing from the rot was not the damage from the direct intrusion of water conveyed by the phrase 'water damage.'

Id. at 941.

In that same year a Texas court considered the ensuing loss provision and found coverage for rot and deterioration of wooden flooring. In *Employers Cas. Co. v. Holm*, 393 S.W.2d 363 (Tex. Civ. App. – Houston 1965, no writ), the stipulated facts revealed that the shower was defectively constructed without a shower pan, which in turn caused water to seep from the shower to the adjacent wood flooring causing the flooring to rot and deteriorate. The court held that the "ensuing loss" provision was applicable and that the loss should be covered under the policy, reasoning that the loss which ensued or followed the water damage grew out of and was caused by water damage. *Id.* at 366.

Seven years later, the Dallas Court of Appeals found coverage under the homeowners ensuing loss clause. In *Merrimack Mut. Fire Ins. Co. v. McCaffree*, 486 S.W.2d 616 (Tex. App. – Dallas 1972, writ ref'd n.r.e.) the insureds hired a contractor to add a bathroom to their home some fifteen years prior to the insurance claim. The contractor who built the additional bathroom failed to install a shower pan beneath the shower, and as a result, water was able to penetrate through the shower stall tile grout and onto the wood structure beneath the shower stall. For fifteen years, the damp environment that was created by this water leak caused the development of fungal infestation, rot and decay of the wood structure.

The court interpreted an ensuing loss provision that is similar to the current exclusion and held that the damage was excluded. However, the court limited its ruling to the facts as they were presented. The court reasoned that for there to be coverage the loss must have been caused by water damage *per se*. *Id.* at 618. The loss would have to come after the water damage, which is not the case here, where, according to the court, the loss was caused by the fungi, not water damage. *Id.*

Shortly thereafter, the San Antonio Court of Appeals analyzed the same exclusion in *Lambros v. Standard Fire Ins. Co.*, 530 S.W.2d 138 (Tex. Civ. App. – San Antonio 1975, writ ref'd) to determine whether insurance coverage applied to structural damage to a home foundation slab caused by subsurface water movement. In that case, the insured argued that the policy should be interpreted such that structural damage to the foundation should be covered when it is caused by and/or "ensues from" water damage. The court rejected this argument and instead construed the ensuing loss provision so that "an ensuing loss caused by water damage is a loss caused by water damage where the water damage itself is a result of the preceding cause." *Id.* at 141. The court reasoned that the ensuing

loss exception requires the conclusion that the water damage must be a consequence, or follow from or be the result of, the enumerated otherwise excluded peril. The court held that because the water damage was the cause, not the consequence, of damage to the foundation, there was no coverage. *Id.*

Another Texas decision concerning mold is *Home Ins. Co. v. McClain*, 2000 WL 144115 (Tex. App. – Dallas 2000) where the Dallas Court of Appeals held there is coverage under the HO-B policy for mold and other fungi damage where the mold/fungi growth was caused by water intrusion. Home Insurance argued that the ensuing loss provision should be interpreted to mean that the policy will cover water damage that results from mold rather than the converse. The court rejected this construction stating that:

> [H]ome ignores that the ensuing loss provision is not limited by the mold and fungi exclusion, and, although the water damage was not the result of the mold and fungi, it was the result of the defective and deteriorated roof.

The court further explained that in order for mold/fungi damage to qualify as an ensuing loss, it must "follow or come afterward as a consequence of the water damage." The court distinguished its opinion in *McCaffree* where the court found that the facts did not support the conclusion that the fungi was caused by the water damage, whereas, in *McClain*, it was undisputed that the mold damage resulted from water intrusion that pooled in the roof crawl spaces.

III. THE POST-*LAMBROS* ANALYSIS OF ENSUING LOSS PROVISIONS

Of special interest are some post-*Lambros* cases discussing how certain courts, pre-*Fiess*, interpreted the ensuing loss provisions in the policies discussed in each case. For example, in *Flores v. Allstate Texas Lloyd's Co.*, 278 F.Supp.2d 810, 2003 WL 22006302 (S.D.Tex. July16, 2003), the United States District Court for the Southern District of Texas, McAllen Division, found that the Plaintiffs' HO-B Policy covered mold damage to the dwelling or to personal property that ensued from an otherwise covered water damage event under the policy. *Id.* at 815.

Mr. and Mrs. Flores purchased a Texas Standard Homeowner's Form B policy ("policy") from Allstate in 1988 and renewed it annually. *Id.* at 812. The Plaintiffs indicated they became concerned about wetness and mold in their home, so they contacted an attorney to advise them. This yielded an investigation, which revealed several leaks and mold growth in the air conditioning unit, hall and master bathrooms, and kitchen sink. The Plaintiffs were seeking coverage only for the ensuing mold damage. In this case, the parties did not argue that the policy was ambiguous and/or that the policy covered ensuing mold damage.

The court stated that Plaintiffs' policy covered all physical loss to both the dwelling ("Coverage A") and certain personal property contained within the dwelling ("Coverage B"), unless otherwise excluded. Coverage A was limited by certain exclusions:

> **"1 … f. We do not cover loss caused by:**
>
> (2) rust, rot, mold, or other fungi…
>
> However, the policy also stated:
>
> **We do cover ensuing loss caused by collapse of building or any part of the building, water damage or**

> **breaking of glass which is part of the building if the loss would otherwise be covered under this policy.**

Id. at 814. The court stated that the policy excluded "loss caused by mold" under Coverage A, unless such loss ensued from water damage if the policy otherwise covered this loss. Therefore, the court stated that the policy provided coverage for mold damage to the dwelling as a distinct loss if it ensued from an otherwise covered loss under the policy. *Id.*

In explaining its analysis, the *Flores* court stated that it had declined to follow the reasoning of *Fiess v. State Farm Lloyds*, Civil Action No. H-02-1912, 2003 WL 21659408 (Southern District of Texas, June 3, 2003), in which the court concluded that the Texas HO-B policies excluded mold damage completely, regardless of the cause, and that mold coverage is also not included under the "ensuing loss" provision when it is caused by water damage. Instead, the court reasoned just the opposite, that ensuing water damage must *result from* an exclusion, such as mold, listed under provision 1(f). *Id.* The court relied on the Fifth Circuit's opinion in *Aetna Casualty and Surety Co. v. Yates*, 344 F.2d 939, 941 (5th Cir.1965). The *Flores* court, however, read *Yates* to support its construction of the mold exclusion as precluding coverage for mold occurring naturally or resulting from a non-covered event, but not for mold "ensuing" from a covered water damage event.

Another post-*Lambros* case interpreting an ensuing loss provision is *Salinas v. Allstate Texas Lloyd's Co.*, 278 F.Supp.2d 820 (S.D.Tex. July 23, 2003). The United States District Court for the Southern District of Texas, McAllen Division held among other things, that the "ensuing loss" provision in the Plaintiffs' policy ("policy") provided coverage for certain mold losses that ensued from otherwise covered water damage events under the policy. *Id.* at 823.

Plaintiffs purchased a Texas Standard Homeowner's Form B policy from Allstate. Plaintiffs' claim for water and mold damage to their home in Weslaco, Texas evolved into a lawsuit filed on June 10, 2002. Both sides moved for summary judgment on different grounds. Of importance here, is Plaintiffs' contention that mold damage is covered under the "ensuing loss" provision of Section 1, Exclusion (f), when it ensues from a covered water damage event. *Id.* at 822.

The court noted that Allstate had conceded in previous court appearances in other mold cases that certain mold damage may be covered under the Texas HO-B policy; however, in this case, its new argument was that mold claims were completely barred under such policies. Allstate relied on the appellate ruling out of Houston, *Feiss* [sic] *v. State Farm Lloyds. Id.* Plaintiffs' partial summary judgment motion, in turn, argued among other things, that mold damage is covered under the "ensuing loss" provision of Section 1, Exclusion (f), when it ensues from a covered water damage.

The court relied on its previous decision in *Flores v. Allstate Texas Lloyds Co.*, previously discussed, in order to reject Defendant's argument that the policy at issue precluded all mold claims, and held that the HO-B policy's "ensuing loss" provision provided coverage for certain mold losses that ensue from otherwise covered water damage events under the policy. *Id* at 823.

IV. THE SUPREME COURT ON THE MOLD EXCLUSION

The United States Court of Appeals for the Fifth Circuit certified the following question to the Texas Supreme Court:

> Does the ensuing loss provision contained in Section I-Exclusions, part 1(f) of the Homeowners Form B (HO-B)

> insurance policy as prescribed by the Texas Department of Insurance effective July 8, 1992 (Revised January 1, 1996), when read in conjunction with the remainder of the policy, provide coverage for mold contamination caused by water damage that is otherwise covered by the policy?

Fiess v. State Farm Lloyds, 392 F.3d 802, 811-812 (5th Cir. 2004). In *Fiess v. State Farm Lloyds*, 202 S.W.3d 744 (Tex. 2006), the Texas Supreme Court ruled that the subject language in the HO-B policy form is not ambiguous and therefore, clearly excludes all loss caused by mold. Judge Brister summarized the Court's opinion as follows:

> The question in this case is not whether insurers should provide mold coverage in Texas, a public policy question beyond our jurisdiction as a court. The question instead is whether the language in an insurance policy provides such coverage, no more and no less.
>
> The policy here provides that it does not cover 'loss caused by mold'. While other parts of the policy sometimes make it difficult to decipher, we cannot hold that mold damage is covered when the policy expressly says it is not. Accordingly, we answer the Fifth Circuit's certified question "No."

202 S.W.3d at 745. The Court refused to consider evidence of prior policy forms and language as presented by the dissent because such evidence is extrinsic and therefore inadmissible unless the policy is ambiguous. *Id.* at 747. The Supreme Court held that ambiguity must be evident from the policy itself, without considering parole evidence of intent. The Court then reaffirmed its long standing rule that insurance policies "must be construed one policy at a time." *Id.*

Then the Texas Supreme Court refused to find the policy terms ambiguous simply because the Texas Department of Insurance adopted the Fiesses's interpretation. While courts do give some deference to an agency opinion or regulation, the Court cautioned that such deference may be placed in three circumstances: (1) formal agency opinions after formal proceedings, (2) where policy language is ambiguous, and (3) where the agency's interpretation is reasonable. *Id.* at 747-748. The Court refused to construe a statewide policy according to what a single regulator, TDI, thought about it.

The Fiesses argued that the exclusion is not applicable because of the "ensuing loss" provision. Recall that the exclusion is modified by "ensuing loss caused by…water damage…if the loss would otherwise be covered under this policy." Reading all parts of the policy together and giving meaning to every sentence, clause and word to avoid rendering any portion inoperative, the Supreme Court disagreed with the Fiesses.

The Court relied upon *Lambros, supra*, in holding that an "ensuing loss caused by water damage is a loss caused by water damage where the water damage itself is the result of a preceding cause." *Id.* at 749 citing *Lambros*, 530 S.W.2d at 141. The Court recognized that it had refused the application of writ of error in *Lambros*, making the opinion with the same force and effect as one of its own opinions. The Court further noted that if the policy interpretation in *Lambros* was wrong, why then did insurance regulators do nothing to change the policy interpretation adopted in *Lambros. Id.* at 749.

The Supreme Court further noted that on the policy language alone, there is no coverage. The ensuing loss exception only

applies to losses from water damage, not water alone. The Court reasoned that in this case, the rot may have ensued from water, but not water damage, and the damage ensuing from the rot was not the damage from the direct intrusion of water conveyed by the phrase "water damage." *Id.* at 750. The Court reasoned:

> Mold does not grow without water; if every leak and drip is "water damage," then it is hard to image any mold, rust, or rot excluded by this policy, and the mold exclusion would be practically meaningless.

Id. Furthermore, the court held that construing the HO-B policy to cover the risks set out in exclusion 1(f) (rust, rot, mold, humidity, etc.) caused by water would convert the homeowners policy into a maintenance agreement. *Id.*

Applying the traditional canon of construction "*noscitur a sociis"* – that a word is known by the company its keeps – the Court held that "water damage", like its neighbors in the ensuing loss exception "building collapse" and "glass breakage", must refer to something more substantial than every tiny water leak or seep. "Water damage" must refer to a kind of uncommon and catastrophic losses for which homeowners obtain insurance, not for common maintenance. The Court concluded that the policy exclusion for mold cannot be disregarded by simply deeming that all mold is "water damage." *Id.* at 751.

The Court also rebutted the dissents position that held the language "if the loss would otherwise be covered under this policy" makes the ensuing loss provision applicable to mold losses. The Court again applied the rules of construction by giving every term meaning. The Court found that the first sentence of 1(f) excludes mold and the second sentence extends coverage to ensuing losses caused by water damage. The Court reasoned that if neither sentence said anything else, the two would conflict whenever water damage (covered) caused mold (excluded). However, by limiting the second clause (ensuing loss clause) to "loss…otherwise covered under this policy", the Court held the only reasonable construction is that the second sentence (ensuing loss) must yield to the first (excluding mold), not the other way around. *Id.* The Court held that the term "otherwise" means "in a different way or manner", meaning the ensuing loss provision does not apply unless the risk is covered. Mold is not covered, and according to the Court, an ensuing loss clause does not make an excluded loss reappear as a covered loss. *Id.*

V. THE IMMEDIATE AFTER-MATH OF *FIESS*

In *Gordon v. Allstate Texas Lloyds,* the United States District Court for the Southern District of Texas granted summary judgment in favor of Allstate based upon the *Fiess* opinion. *See Gordon v. Allstate Texas Lloyds,* 2006 WL 2827233, (S.D. Tex. 2006). Prior to the *Fiess* decision, the *Gordon* court denied Allstate's summary judgment motion as to the Gordons' several breach of contract claims for mold damage on the grounds that there were disputed fact issues material to determining whether the alleged mold damage was caused by a covered loss. *Id.* at *1. At that time, the court noted that if the Texas Supreme Court determined in *Fiess* that all mold damage is excluded from coverage, summary judgment would be appropriate. *Id.*

In light of the certified question pending in the Texas Supreme Court in *Fiess*, the *Gordon* court chose to stay the case. Once the *Fiess* opinion was rendered, the *Gordon* court reopened the case to resolve the remaining breach of contract claims. *Id.* Applying *Fiess*, the court reasoned that the breach of contract claims based on Allstate's refusal to pay for mold contamination were no longer viable. *Id.* The court initially found a disputed fact issue as to whether the water damage that

caused the mold was "otherwise covered" under the policy, but after *Fiess*, the court held that even if the water damage was otherwise covered, the resulting mold contamination is not. *Id.*

The Gordons argued further that *Fiess* is not dispositive because of the exclusion repeal provision found in the Coverage B section of the policy. *Gordon* at *2. The HO-B policy has two subparts: Coverage A deals with damage to the dwelling, while Coverage B concerns damage to the insured's personal property. Coverage B provides the insured with coverage under twelve specific perils, including coverage for accidental discharge or overflow of water from plumbing systems, air conditioning systems, or household appliances (the "accidental discharge provision"). *Id.* The accidental discharge provision contains a clause that specifically prohibits application of the section 1 exclusions (the "exclusion repeal clause"). *Id.* While this clause is contained within personal property coverage section, the Gordons argued that the exclusion repeal clause applies to both personal property damage and damage to the dwelling itself. *Id.* The Gordons relied on *Balandran v. Safeco Insurance Co. of America*, 972 S.W.2d 738 (Tex.1998) in support of their position.

In *Balandran*, the insureds sued their homeowner's carrier for foundation damage caused by a plumbing leak. The *Balandran* dispute involved exclusion 1(h), which states, "We do not cover loss under Coverage A (Dwelling) caused by settling, cracking, bulging, shrinkage, or expansion of foundations, walls, floors, ceilings, roof structures, walks, drives, curbs, fences, retaining walls or swimming pools." *Balandran*, 972 S.W.2d at 739. The Texas Supreme Court reasoned that because the section 1(h) exclusion only applies to damage to the dwelling, in order to give meaning to the exclusion repeal clause, the accidental discharge provision had to apply to both Coverage A and Coverage B. *Id.*

The Gordons argued that *Balandran* applies to all of the section 1 exclusions, including the mold exclusion. *Gordon* at *2. This would mean that if the damage to their dwelling was caused by accidental discharge of water, then the exclusion repeal clause would apply, negating the mold exclusion found in section 1(f), thereby providing coverage for mold damage to their dwelling. However, the *Gordon* court found a distinction in the application of exclusion 1(h) and 1(f). *Id. S*ection 1(h) deals with damage to the dwelling itself while Section 1(f) precludes recovery for damage to the dwelling *or* to personal property. The *Gordon* court determined that because exclusion 1(f) applies to both the dwelling and personal property, the exclusion repeal provision can only apply to personal property damaged by mold. *Id.* Since *Fiess* held that mold damage to a dwelling is excluded regardless of whether the water damage causing the mold was otherwise covered, applying the exclusion repeal provision to render the mold exclusion meaningless would produce a result inconsistent with *Fiess*. The court held that because the Gordons' claims are for mold damage to their dwelling, *Fiess* controls. *Id.*

Another post-Fiess case from the Southern District of Texas, *Smith v. Allstate Ins.*, has been dismissed because of the absence of mold coverage. *See Smith v. Allstate Ins*., 2007 WL 677992 (S.D. Tex. 2007). The *Smith* case stems from water damage as a result of a tropical storm that flooded much of Houston, Texas on June 9, 2001. *Smith* at *1. However, Bettie Smith argued that the water damage to her home was caused by overflowing toilets, not the entry of flood water from the tropical storm. *Id.* Her homeowner's policy covered damage caused by water flowing from a plumbing or air conditioning leak but did not cover damage caused by flooding from external water that enters the home. *Id.*

Prior to the Fiess opinion, the *Smith* court ruled that there a disputed fact issue regarding the origination of the water that

caused the mold and whether certain mold damage occurred before the tropical storm. *Id.* at *3. The court then stayed the case pending the *Fiess* decision. *Id.* After the *Fiess* opinion, the court found that Allstate was entitled to summary judgment because the previously disputed fact issues were no longer material to Smith's breach of contract claims. *Id.* at *4. The court explained that "It does not matter whether the water that caused the mold came from flood waters during the tropical storm or from a sewage backup. Under *Fiess*, the mold damage is not covered under Smith's Texas HO-B insurance policy." *Id.*

VI. LEGACY OF *FIESS* ON RULES OF POLICY CONSTRUCTION

The Supreme Court spent a great deal of time in *Fiess* addressing the rules of insurance policy interpretation, especially those rules relating to ambiguities. The rules set out by the Court and their application are as follows (citation omitted):

A. If the policy provision has only one reasonable interpretation, it is unambiguous and must be construed as a matter of law.

- A provision is not ambiguous merely because different parties or different courts have interpreted it differently.
- The actual intent of parties is not what counts when involving standard form policy language mandated by a state regulatory agency, but the everyday, ordinary meaning of the words to the general public.

The Court concluded that there is no ambiguity in the ordinary meaning of the terms "We do not cover loss caused by …mold…."

B. Ambiguity must be evident from the policy itself; it cannot be created by introducing parole evidence of intent.

The Court refused to look at the preceding HO-B policy as suggested by the dissent because the Court held that insurance policies must be construed one policy at a time.

The Court also refused to give deference to the Texas Department of Insurance's position when determining whether the exclusion is ambiguous. The Court ruled that an agency's opinion can help construe an existing ambiguity, but not create one. The policy is not ambiguous simply because the Department agrees with the Fiess' construction.

C. All parts of the policy must be read together, giving meaning to every sentence, clause, and word to avoid rendering any portion inoperative.

The Court interpreted the ensuing loss exception such that the terms "ensuing loss caused by …water damage…" refers to water damage which is the result, rather than the cause, of "rust, rot, mold or other fungi…."

Furthermore, the Court addressed the meaning of the terms "water damage" and concluded that the ensuing loss clause provides coverage only if something more substantial than a water leak or seep occurs, a more uncommon and catastrophic losses occurs. Otherwise, because mold does not grow without water, the mold exclusion would be practically meaningless.

The dissent made the argument that the ensuing loss clause cancels the mold exclusion because of the last phrase "if the loss would otherwise be covered under this policy." The dissent argued that phrase requires the reader to disregard the exclusions, which is in violation of the rules of construction by rendering a portion of the policy meaningless. However, the Supreme

Court held that the only reasonable interpretation is that the ensuing loss section must yield to the mold exclusion, not the other way around.

VII. CONCLUSION

The Texas Supreme Court provides a template of rules of contract construction applicable to homeowners insurance policies in the *Fiess* case that should prove useful in future ensuing loss claims.