

Emerging Coverage Issues in First Party Mold Claims

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This article will address key areas of controversy which continue to surround coverage for first party mold claims. These areas concern the interplay of ensuing loss provisions with certain exclusions in standard homeowners' policies that are often asserted as the basis for the denial of coverage. Those exclusions include continuous seepage or leakage of water, latent defects, mold, and construction defects.

Confusing policy language and conflicting judicial decisions contribute to the turmoil concerning the proper application of these exclusions to an ever-increasing number of water and mold claims. In order to appreciate the magnitude of the problem, one must consider that there has been "a three-fold increase in mold-related lawsuits the past three years." (See "Lawsuits, Insurance Claims Over Mold Damage on the Rise," *USA Today*, July 17, 2003.) According to that recent article: "There are 10,000 such cases pending today nationwide, the Insurance Information Institute says."

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The primary focus of this article will be on cases from California, which, along with Washington, applies an efficient proximate cause analysis. In contrast, jurisdictions such as Arizona and Texas do not apply that analysis. This difference explains some of the lack of consistency among judicial decisions in this developing area of the law.

Exclusions for Continuous Seepage and Latent Defects

Water damage claims are probably the most common claims made under homeowners' policies. Since these are typically "all-risk" policies, any peril that is not specifically excluded is covered. Most homeowners' policies exclude certain types of "water damage," such as flood and surface water, but other types of water damage, such as sudden pipe leaks, are usually covered. The issue of coverage for leaks of long term duration has been a subject of controversy.

The continuous seepage exclusion in the standard homeowners' policy usually reads something like:

We do not insure loss caused by: constant or repeated seepage or leakage of water or steam over a period of weeks, months or years, from within a plumbing, heating, air-conditioning or automatic fire protective sprinkler system or from within a household appliance.

The exclusion seems simple enough, inasmuch as any leak that exists 15 or more days apparently is not covered. But what about a leak hidden inside a wall or under a floor, which the insured could not have known existed until more than 14 days had passed? There are no published cases in California on this issue. Insurance industry custom and practice, however, would seem to indicate that coverage should still exist in such circumstances.

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For example, the Fire Casualty & Surety ("FC&S") Bulletin, published by National Underwriter Company, takes the position that hidden water damage from a leaking pipe is covered.¹ This would be the case even if the leak continued for a lengthy period, so long as the damage was reported by the insured as soon as he or she became aware of it. As the FC&S Bulletin indicates, the continuous seepage or leakage exclusion is only intended to apply to the situation where the insured has not fulfilled his or her duty of promptly reporting the loss as soon as they became aware of it. This is a reasonable approach, since it would be unfair to penalize an insured for not promptly reporting an otherwise covered water loss of which he or she had no knowledge.

Standard homeowners' policies also typically exclude coverage for losses caused by "latent defects." A latent defect can include any kind of defect: "Faults, flaws and irregularities can be the result of faulty construction, just as much as mere weakness of material." (*Scott v. Continental Ins. Co.*, 44 Cal.App.4th 24, 35, 51 Cal.Rptr.2d 566, 573 (1996).)² Such a broad definition for latent defects is important because, while the defect itself is excluded from coverage, any non-excluded water damage that results from it should still be covered as long as the exclusion contains an "ensuing loss provision."

Ensuing Loss Provisions

The continuous seepage and latent defect exclusions are typically listed in the policy with other exclusions such as wear and tear, marring and deterioration. That list of exclusions is often followed by an "ensuing loss" clause, which generally reads something like:

If any of these excluded causes of loss result in a covered cause of loss, we will pay for that ensuing loss or damage.

An "ensuing loss" provision acts as an exception to the exclusion. If an excluded peril, e.g., a latent defect, results in a covered peril, e.g., a broken pipe, then the insurer will pay for the loss or damage caused by the covered peril. Under such

language, coverage is available—notwithstanding the exclusion—as long as the ensuing loss is separate from and in addition to the initial excluded peril. For example, in *Acme Galvanizing Co. v. Fireman's Fund Ins. Co.*, 221 Cal.App.3d 170, 179-180, 270 Cal.Rptr. 405, 411 (1990), an insured sought coverage under its "all risk" policy for damage caused when a steel kettle ruptured, allowing several tons of molten zinc to spill onto surrounding equipment. Noting that latent defects are "not apparent by reasonable inspection," the *Acme* court found that the latent defect exclusion applied because the rupture was due to a defective internal weld observable only after the performance of destructive testing. However, the court pointed out that "[i]f the molten zinc had ignited a fire or caused an explosion which destroyed the plant, then the fire or explosion would have been a new covered peril with the ensuing loss covered."

On the other hand, if the ensuing loss or damage is also excluded under the policy, then there is no coverage for that loss or damage. For example, in *Murray v. State Farm Fire & Casualty Co.*, 219 Cal.App.3d 58, 268 Cal.Rptr. 33 (1990), a copper pipe beneath a concrete slab ruptured as a result of corrosive acidic soil, which caused a crack in the slab. The initial peril was the corrosion of the pipe. This peril was excluded under the "deterioration" exclusion. The subsequent peril was the cracking of the slab. Because the damage to the slab was also specifically excluded under the policy, under the separate exclusion for "settling, cracking, shrinking" of foundations, there was no coverage for the ensuing loss. *Id.*, 219 Cal.App.3d at 65.

Some ensuing loss provisions are limited by their own terms to ensuing damage or loss caused by fire or by water. Certain of the ensuing water damage clauses require that the water escape "suddenly and accidentally" from a plumbing system. In that regard, it may be useful to look at pollution cases, which hold that the term "sudden" refers only to the commencement of the loss. Thus, to be covered, the loss need not terminate quickly or have been only of brief duration. (*Vann v. Travelers Cos.* 39 Cal.App.4th 1610, 1617, 46 Cal.Rptr.2d

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617, 621 (1995); *Shell v. Winterthur Ins. Co.* 12 Cal.App.4th 715, 756, 15 Cal.Rptr.2d 815, 841-42 (1993).)

There are no published cases in California applying the ensuing loss doctrine in the context of water damage and mold. Cases in other jurisdictions have gone both ways on the issue. Cases which have found that the ensuing loss clause did not apply to provide coverage include: *Merrimack Mutual Fire Ins. Co. v. McCaffree*, 486 S.W.2d 616, 619-20 (Tex. App. — Dallas 1972); *Aetna Casualty & Surety Co. v. Yates*, 344 F.2d 939, 941 (5th Cir. 1965) (applying Texas law); and *Ames Privilege Assocs. Ltd. v. Utica Mutual Ins. Co.*, 742 F.Supp. 704, 707 (D.Mass. 1990).

In contrast, the following cases found that the ensuing loss clause provided coverage for water damage and mold: *Home Ins. Co. v. McClain*, 2000 WL 144115 (Tex. App. — Dallas 2000) (not designated for publication) (distinguishing *Merrimack*)³; *Blaine Const. Corp. v. Ins. Co. of No. Am.*, 171 F.3d 343, 349-350 (6th Cir. 1999) (applying Tennessee law) (distinguishing *Yates*); *Bruce Oakley, Inc. v. Farmland Mutual Ins. Co.*, 245 F.3d 1027, 1029 (8th Cir. 2001) (applying Arkansas law)⁴; *Employers' Casualty Co. v. Holm*, 393 S.W.2d 363 (Tex. App. — Houston 1965); and *Allstate Ins. Co. v. Smith*, 450 S.W.2d 957 (Tex. App. — Waco 1970).

In *Employers' Casualty Co. v. Holm*, *supra*, the homeowner's all-risk insurance policy excluded loss caused by inherent vice or rot, but those exclusions contained an exception for ensuing loss specifically caused by water damage. The homeowner alleged that his home was constructed without a shower pan under the shower stall, with the inevitable result that water passed into the wood and cork flooring of the house, causing rot and deterioration so that the floor had to be replaced. The Texas Court of Appeals found coverage for the damage to the floor, notwithstanding the exclusions. Distinguishing *Aetna Casualty and Surety Co. v. Yates*, the court noted that the parties in the instant case stipulated that the water passing into and under the wood flooring of the house caused it to rot and deteriorate. The court noted that it is a matter of common knowledge that the more or less continual application of

water to and against the wooden flooring of a house would cause warping and cracks and water damage which would finally result in rot and deterioration. Thus, the ensuing loss provision for "water damage" applied to allow coverage for the loss. (*Employers' Casualty Co. v. Holm*, *supra*, 393 S.W.2d at 366.)

In *Allstate Ins. Co. v. Smith*, *supra*, a homeowner's all-risk policy contained an exclusion for loss caused by inherent vice, wear and tear, deterioration, and rust, with an exception for ensuing loss caused by water damage which would otherwise be covered. A water pipe in a concrete slab of the house ruptured and the leaking water caused rotting and deterioration of wood beams and plates. The Texas Court of Appeals found that the inherent vice was a defective copper pipe (caused either by defect of the manufacturer or by crimping by a workman when it was installed), and that no recovery was allowed for the cost of the replacement of the pipe. However, the court also found that the cost of tearing out the floor and walls to find the source of the leak and the cost of replacing them was covered because the water damage caused by the unforeseeable bursting of a pipe was a covered risk of physical loss as contemplated by the policy. The "ensuing loss" from the water damage necessarily included the cost of tearing out and reconstructing the wall and floor. (*Allstate Ins. Co. v. Smith*, *supra*, 450 S.W.2d at 959.)

Mold: An Excluded Peril or Covered Loss?

Some carriers have taken the position that while water damage which results from an inherent vice or a continuous water leak is covered, the mold that results from that water damage is still excluded. Within the last two years, other carriers have begun covering the water damage and mold damage together; however, pursuant to endorsement, the mold damage is subject to a sublimit, e.g., \$5,000. It is difficult, both analytically and practically, to separate the water damage from the mold damage in such circumstances. This is particularly true where they coexist, which is frequent because the presence of moisture is necessary for mold growth.

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Part of the confusion stems from the fact that some courts use the terms "peril" and "loss" interchangeably. For example, in the often-cited California case *Acme Galvanizing Co., Inc. v. Fireman's Fund Ins. Co.*, *supra*, the court stated: "We interpret the ensuing loss provision to apply to the situation where there is a 'peril,' i.e., a hazard or an occurrence which causes a *loss or injury*, separate and independent but resulting from the original excluded peril, and this *new peril* is not an excluded one, from which loss ensues." (221 Cal.App.3d at 179-80 [Emphasis added].)

The word "peril" should be distinguished from the word "loss." The term "peril" in a property insurance policy refers to a fortuitous, active, physical force, such as lightning, wind, and explosion, which brings about a loss. (*Garvey v. State Farm & Fire Casualty Co.*, 48 Cal.3d 395, 406, 257 Cal.Rptr. 292, 298, 770 P.2d 704 (1989); *Hoffman v. State Farm & Fire Casualty Co.*, 16 Cal.App.4th 184, 189-190, 19 Cal.Rptr.2d 809, 812 (1993).) Under a first party policy, a "loss" is the amount of indemnity the insured is entitled to receive in order to repair or replace the damaged property to its condition prior to the loss. (See, e.g., *Palma v. Watson Surplus Lines Agency*, 148 Cal.App.2d 879, 886-87, 307 P.2d 689, 693-94 (1957).)

The cases that have found coverage for mold as an "ensuing loss" view it as a form of loss or damage, rather than as a distinct, excluded peril. This makes sense, because the insurance policies that exclude mold tend to do so in the context of mold as a "cause of loss," rather than as the loss itself. A good illustration of this distinction can be found in the case of *Liristis v. American Family Mutual Ins. Co.*, 204 Ariz. 140, 61 P.3d 22 (App. 2002).

In *Liristis*, mold resulted from water damage after a fire in the policyholder's home, as well as from roof leaks which followed the fire. The insurer denied coverage based on the mold exclusion. The appellate court reversed the summary judgment in favor of the insurer because there were triable issues of fact regarding causation. The appellate court held that it would be up to the factfinder to determine whether the mold was

caused by the covered peril of fire, in which case the cost of remediation of the mold would be covered as an ensuing loss. Alternatively, if the mold were not caused by fire, but rather than by an excluded peril, there would be no coverage. Also, if the mold was determined not to be an ensuing loss from a covered peril, but rather the cause of the loss itself, it would also fall within the exclusion, and coverage would be denied. (*Id.*, 61 P.3d at 27-28.)

However, other cases have held that to interpret the ensuing loss provision in this manner would be to ignore the purpose of an express exclusion. An example is the case of *Schloss v. Cincinnati Ins. Co.*, 54 F.Supp.2d 1090 (M.D. Ala. 1999), *aff'd*, 211 F.3d 131 (11th Cir. 2000). In *Schloss*, the insured argued that his losses were not subject to a "loss caused by rot" exclusion because those losses were not "caused by rot" but were rot itself. The court rejected that interpretation, because it would effectively "gut the listed exclusions." (*Id.* at 1095-96.)

There are a number of unpublished cases available on Westlaw that discuss the effect of the ensuing loss clause on mold claims. These cases also fall on both sides of the issue. Due to the lack of precedential effect of these cases, they will not be discussed in this article. For the purpose of demonstrating how different judges tend to have vastly differing views on this issue, however, two new cases out of the United States District Court, for the Southern District of Texas, are worth noting.

In *Fiess v. State Farm*, 2003 WL 21659408 (S.D. Tex. June 4, 2003), the court concluded that a mold exclusion operated to exclude mold damage completely, regardless of cause, and notwithstanding that exclusion's ensuing loss provision which provided coverage for losses resulting from water damage. The court held that the water damage had to "ensue" from the mold in order for any resulting losses to be covered. In contrast, on July 16, 2003, a different judge from the same federal court declined to follow *Fiess*. (*Flores v. Allstate Texas Lloyd's Co.*, 2003 WL 21713773 (S.D. Tex. July 16, 2003).)⁵ The court in *Flores* found that a

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virtually identical exclusion and ensuing loss provision covered mold damage which ensued from a loss otherwise covered under the policy (such as water damage).

In light of the above, there appears to be an ambiguity surrounding the issue as to when mold should be excluded as a separate "peril" rather than covered as an "ensuing loss."⁶ To the extent the policy language is ambiguous, the goal of the court is to protect the objectively reasonable expectations of the insured. (*AIU Ins. Co. v. Superior Court*, 51 Cal.3d 807, 821-22, 274 Cal.Rptr. 820, 831, 799 P.2d 1253 (1990).) A reasonable insured would probably expect that if water damage resulting from an excluded peril (such as constant leakage) was covered as an ensuing loss, then the mold that results from that water damage would also be covered.

On the other hand, mold that simply takes the form of long term "deterioration" would be nonfortuitous and generally excluded as a cause of loss. Thus, mold resulting from naturally occurring climatic conditions, which cause a high moisture content in the atmosphere, ordinarily would not be covered. This is significant because most of the mold claims come from southern states like Texas and Florida, where there is high humidity and hurricanes, and coastal states like California and New York, which have damp coastal areas. As one might expect, other areas of the country, such as the Midwest, have far fewer mold claims.

Although there are as yet no published mold coverage cases in California, the growth of mold caused by weather-related moisture in the atmosphere can be analogized to the slow deterioration that occurs from corrosive materials in the soil. "Weather conditions" and "deterioration" are both excluded causes of loss in many property policies. A number of appellate decisions in California hold that naturally caused corrosive conditions are excluded as deterioration. (*See, e.g., Murray v. State Farm Fire & Casualty Co.*, *supra*, 219 Cal.App.3d at 63; *Butki v. United Servs. Auto. Ass'n*, 225 Cal.App.3d 464, 467, 274 Cal.Rptr. 909, 910 (1990) (high level of sulfates in soil); and *Brodkin v. State Farm Fire & Casualty Co.*, 217 Cal.App.3d 210, 217,

265 Cal.Rptr. 710, 714 (1989) (cow urine, swamp seepage or other corrosives in soil).) Accordingly, mold resulting from natural environmental factors probably will be subject to the mold exclusion.

Construction Defect Exclusion

Some construction defect exclusions contain their own ensuing loss clause. For example, one typical formulation of the ensuing loss clause reads as follows:

We do not insure for loss to property caused by any of the following: faulty, inadequate or defective workmanship, repair, construction materials used in repair, construction, or maintenance. However, any ensuing loss to property not excluded or excepted in this policy is covered.

In the face of a construction defect exclusion which contains such a clause, the ensuing loss analysis discussed above should apply. Therefore, if the construction defect causes a loss that is not excluded by the policy (e.g., water damage), that loss should be covered.

Moreover, even if the construction defect exclusion does not contain an ensuing loss provision, it might conflict with the ensuing loss clause which usually applies to the latent defect/inherent vice exclusion discussed above. This is because the exclusions for construction defects and latent defects can overlap, since the "latent defect" exclusion also includes "negligent construction." (*See, e.g., Chadwick v. Fire Ins. Exchange*, 17 Cal.App.4th 1112, 1121-25, 21 Cal.Rptr.2d 871, 876-79 (1993).) Therefore, if coverage is provided by an ensuing loss clause that applies to a latent defect exclusion, it makes no sense that coverage would be precluded pursuant to a separate construction defect exclusion.

Efficient Proximate Cause Doctrine

In the absence of an ensuing loss clause which attaches to a construction defect exclusion, one must apply the "efficient proximate cause" analysis in jurisdictions which recognize it. In those jurisdictions, first party property claims are covered if an insured peril is the efficient proximate

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cause of the loss, even if non-insured perils may also have contributed to the loss. (See *Garvey v. State Farm Fire & Casualty Co.*, *supra*, 48 Cal.3d at 408; *Sabella v. Wisler*, 59 Cal.2d 21, 25-27, 27 Cal.Rptr. 689, 692, 377 P.2d 889 (1963).)

This analysis determines whether the predominant cause of the loss was a covered, as opposed to an excluded, peril under the policy. For example, take the situation where a pipe break has concurrent causes, one of which is excluded (e.g., earth movement) and the other of which is covered (e.g., third-party negligence which caused the earth movement). The loss itself is covered if the predominant cause was the third-party negligence. (See *State Farm Fire & Casualty Co. v. Von Der Lieth*, 54 Cal.3d 1123, 1133, 2 Cal.Rptr.2d 183, 189-190, 820 P.2d 285 (1991); *Sauer v. General Ins. Co.*, 225 Cal.App.2d 275, 278, 37 Cal.Rptr. 303, 305 (1964) (leakage of water from plumbing system covered, but sinking of earth excluded).)

On the other hand, where there is only one cause of loss, which is itself excluded, then there is no coverage. (See *Finn v. Continental Ins. Co.*, 218 Cal.App.3d 69, 71-72, 267 Cal.Rptr. 22, 23-24 (1990) (no concurrent causes of leaky pipe).) Various cases from around the country have applied the efficient proximate cause doctrine to find coverage in circumstances involving water damage and mold. For example, a Washington appellate court held that the marijuana cultivation by tenants, which created a hot and humid atmosphere in the basement of a rental house, was the efficient proximate cause of mold damage to the remainder of the house. Because the efficient proximate cause of the loss was covered vandalism by the marijuana-growing tenants, the landlord's insurance policy covered the mold damage, despite the fact that the policy contained a mold exclusion. (*Bowers v. Farmers Ins. Exchange*, 99 Wash.App. 41, 991 P.2d 734, 738 (2000).)

Another Washington appellate court held that there was an issue of fact for the jury to decide as to whether wind-driven rain or fungus was the efficient proximate cause of dry rot damage to a condominium building. Because it was not ex-

cluded from the plaintiff's all-risk insurance policy, wind-driven rain was a covered peril. Fungus, on the other hand, was specifically excluded. Expert testimony identified rain as the cause of the fungus which resulted in damage to the building. Therefore, according to the court, the policy's fungus exclusion did not necessarily bar recovery for fungus damage if the jury found the wind-driven rain to be the efficient proximate cause of that damage. (*Sunbreaker Condominium Ass'n v. Travelers Ins. Co.*, 79 Wash.App. 368, 901 P.2d 1079, 1084 (1995).)⁷

Similarly, the Eighth Circuit Court of Appeals reversed a summary judgment for a homeowner's insurer for further findings as to whether a burst water pipe (a covered peril) or mold (an excluded peril) was the efficient proximate cause of the policyholder's loss. (*Shelter Mutual Ins. Co. v. Maples*, 309 F.3d 1068, 1070-71 (8th Cir. 2002) (applying Arkansas law).) In sum, a construction defect exclusion should not bar coverage if the predominant cause of the mold is a form of water damage not otherwise excluded under the policy.

An example of what happens in a jurisdiction that does not apply an efficient proximate cause analysis can be seen in *Cooper v. American Family Mutual Ins. Co.*, 184 F.Supp.2d 960 (D.Ariz. 2002) (distinguished by *Shelter Mutual Ins. Co. v. Maples*, *supra*, 309 F.3d at 1071). In *Cooper*, a homeowner's all-risk policy covered damage resulting from certain water events, but explicitly excluded mold damage. A plumbing leak damaged dry wall and flooring. The insurer paid for repairs to the drywall and flooring, but denied coverage for damage caused by mold. The insured claimed that because the water damage was a covered loss, the resulting mold from the introduction of water was also covered under the "efficient proximate cause" rule. However, the court pointed out that Arizona has not adopted that rule and, therefore, an insurer is permitted to limit its liability for concurrent causation. Accordingly, the court held there was no coverage for losses caused by mold, even though a covered water event may have contributed to the loss.⁸ (*Id.* at 962.)

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Conclusion

The continuous seepage, latent defect and mold exclusions are often qualified by an ensuing loss provision which serves as an exception to the exclusions. The exception should apply so that water damage and mold claims are covered to the extent that they result from a peril which is not otherwise excluded, such as a plumbing leak, which itself resulted from an excluded peril, such as a latent defect.

In those jurisdictions which apply an efficient proximate cause analysis, such as California and Washington, it is easier to find coverage for mold claims. That is not to say that coverage for mold can always be found. The exclusions for mold and deterioration may still bar coverage in the common situation of long-term exposure to natural conditions.

Mold coverage cases tend to be very fact specific. Since the efficient proximate cause of a loss is often a factual question, one must keep in mind that juries tend to be sympathetic to insureds in these cases. Finally, there is surprising variation in the standard forms being used to write property damage policies in states like California. Therefore, as always, close attention must be paid to the specific language of the policy, as well as the controlling law of the jurisdiction.

Footnotes

¹ The FC&S Bulletin is used by insurance agents and brokers to interpret standard insurance policy provi-

sions. (See *Maryland Casualty Co. v. Reeder*, 221 Cal.App.3d 961, 972, 270 Cal.Rptr. 719, 725 (1990).) It is also used by insurance companies and adjusters. Most courts and commentators have recognized that the presence of standardized industry provisions and availability of such interpretive literature are of considerable assistance in determining coverage. (*Montrose Chemical Corp. v. Admiral Ins. Co.*, 10 Cal.4th 645, 670, 42 Cal.Rptr.2d 324, 337, 897 P.2d 1 (1995).)

² The same may be said of "inherent vice," but this is an "arcane" term and its precise meaning is less clear. (See, e.g., *Opsal v. United Servs. Auto. Ass'n*, 2 Cal.App.4th 1197, 1204, 10 Cal.Rptr.2d 352, 356 (1991).) Therefore, most of the case law deals with the companion "latent defect" form of the exclusion.

³ The *McClain*, *Merrimack* and *Yates* cases were discussed in the author's prior article, "Insurance Coverage for the Epidemic of Mold Litigation Plaguing the Construction Industry," 22 *Construction Litigation Reporter* 315 (2001).

⁴ The *Bruce Oakley* case applies both an ensuing loss and an "efficient cause" analysis.

⁵ *Flores* is expected to be published in the official reporter very shortly; it is not yet known if *Finess* will be published.

⁶ However, the Washington Supreme Court stated, in *McDonald v. State Farm Fire & Casualty Co.*, 119 Wash.2d 724, 837 P.2d 1000, 1005 (1992), that: "The ensuing loss clause may be confusing, but it is not ambiguous."

⁷ The *Bowers* and *Sunbreaker* cases are also discussed in the same article referenced in footnote 3.

⁸ The *Cooper* case is discussed in the author's article, "Insurance Coverage for Mold Claims: Update on 2002 Cases," 23 *Construction Litigation Reporter* 319 (2002).