

Mortgage Lending Alert

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Mold Contamination of Mortgaged Property: A New and Significant Legal Issue for Lenders

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Mold contamination in residential dwellings and commercial buildings has become an important legal issue. The recent \$32 million verdict in Texas, and smaller verdicts and settlements in other cases across the country, have awakened the plaintiffs' bar to the possibility that there may be a "pot of gold" at the end of a moldy rainbow. To date, the mold litigation has involved primarily (1) homeowners suing their homeowner insurance companies, builders and/or architects, and (2) tenants suing their landlords and/or management companies. However, plaintiffs are always looking for a deep pocket in these cases, and historically, the lending community has provided an enticing target in real estate claims.

If the default and foreclosure rate on both residential and commercial loans increases, lenders will find themselves considering whether to become owners of a structure containing mold or other bacterial or fungal contamination. This alert addresses some of the key issues with which lenders must be familiar when making lending decisions, and in particular, when deciding to foreclose and resell property with known bacterial or fungal contamination.

Pre-Loan Issues

Lenders have conducted due diligence on property securing large commercial loans for some time. However, until recently, most lenders did not

include a test for fungal or bacterial contamination in the standard due diligence package. Indeed, the standard due diligence protocol set out in the ASTM Guidelines does *not* include fungal and bacterial contamination. Many lenders have begun to add these tests to their standard due diligence package. The decision whether the incremental cost of performing these tests is money well spent may depend on whether the loan is for residential or commercial property.

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In the residential context, lenders may secure an appraisal, but they do not typically conduct due diligence. Inspection of the property securing the residential mortgage is conducted by home inspectors hired by the purchasers/borrowers. Unfortunately, the quality of these home inspectors varies greatly, and lenders rarely are involved in the decision making process to hire the home inspector. Many home inspectors have no licenses and are not "expert" in any aspect of home construction or maintenance. Certainly, the typical home inspection does not include a sample for fungal or bacterial contamination. Mold problems may come to light only if the inspector notes evidence of water damage or prior water leaks.

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Without proper due diligence, a lender may find that the value of the residential property is significantly compromised by fungal or bacterial contamination. On the other hand, borrowers will likely address water damage to their primary residence and not permit mold growth to continue so as to create a significant threat to their own health or to the value of the property. Lenders must determine whether to require mold testing and inspections as a pre-loan condition, whether to pass any testing costs on to borrowers and whether adopting these requirements will place the lender at a competitive disadvantage in the marketplace.

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With commercial loans, lenders typically conduct more detailed due diligence and should consider adding mold inspection and testing to the due diligence requirements. Performing these additional inspections and testing is a much easier decision with commercial loans than residential loans. The increased incremental costs should not have an anti-competitive effect in the commercial loan market. Also, the potential effects of mold on commercial occupants or members of the public using the building and on the borrower’s income stream for paying back the loan justify this due diligence.

Post-Loan Issues

Even if a lender were to require a pre-loan mold investigation, that does not guarantee that the property will not present mold issues over the course of the loan. If conditions arise that promote mold growth -- a water source, a food source for mold (such as typical building materials), and the

appropriate relative humidity and temperature -- mold can proliferate after the loan is made. Thus, the lender can not eliminate mold contamination risk completely by performing due diligence. In commercial loans, lenders have the right in most lending documents to enter and inspect the premises to guarantee the sufficiency of the collateral. Lenders rarely, if ever, exercise that option.

If a serious mold problem arises on the property during the course of the loan, the borrower may go into default. In the typical commercial loan and security agreement, the lender has broad powers to act to protect its collateral in the event of a default. Such powers often include (1) paying or compromising bills that may become liens against the collateral; (2) using any loan balance not yet disbursed to pay for renovation of the property; (3) using its own funds to renovate the property; and (4) a right to entry, possession and use of the property. There are always the additional options of forbearance or foreclosure.

Lender Liability

Any of these options presents risks to be considered. Of course, any exercise of control of the situation by the lender raises the specter of “lender liability.” While control is often the code word justifying imposition of liability on the lender in a given situation, it is not the sole consideration. The lender’s potential liability does not arise from the mere existence of control, but must include either a breach of contract or commission of a tort.

Among the common contract claims against lenders is breach of the covenant of good faith and fair dealing implied in the loan documents. Whether the lender chooses in a particular situation to forbear or foreclose, it can minimize the

risks of a claim of a breach of the covenant of good faith and fair dealing by: (1) acting deliberately and not hastily; (2) consulting with the borrower and considering carefully the borrowers' plans; (3) sticking with whatever plan is developed; and (4) if the lender must change the plan, documenting clearly the reasons for the change.

Waiver and estoppel are sometimes used as a basis for claiming lender liability. If the lender chooses to forbear, the forbearance agreement should be for a limited time and contain clear language indicating that a broader waiver is not intended.

Another contractual basis for imposing lender liability is the theory of anticipatory breach, where the lender indicates it is no longer willing to perform its contractual obligations. This situation may arise where the lender repudiates an agreement to fund the mold remediation, or the mold remediation will be extensive and the lender no longer wishes to forbear on the loan, or the lender requires previously unstated conditions, such as demanding that the borrower perform the remediation in a particular way or to a particular level or standard.

Tort liability theories that may arise from a lender's "control" of a mold contamination problem may include fraudulent concealment. If the lender is aware of the mold contamination problem and exercises sufficient control of that problem, but allows others unaware of the problem to be exposed to the mold, it could be subject to a tort liability claim.

In some situations, the lender may deem it prudent to foreclose rather than pursue any other option. Because there will always remain a risk of

mold contamination, if the lender has no information concerning the mold conditions at the property, it should consider a pre-foreclosure inspection of any property for which it anticipates taking title. Although this practice will add time and expense to the foreclosure process, it may well save lenders a far greater sum if it prevents taking title to fungal or bacterially contaminated property. If the lender is aware of a mold condition on the property to be foreclosed, it should understand that it will assume responsibility for the mold contamination along with title to the property. This situation presents the lender with a real Hobson's choice, either to walk away from the loan entirely or incur additional expenditures in the hope of recovering something on the loan when the remediation is complete. The *pre*-foreclosure sampling will enable the lender to evaluate the extent of the mold contamination, to estimate the potential remediation costs and to avoid owning property where the mold contamination may be so extensive that the structure must be demolished.

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Lender Do's and Don'ts

Once a lender has obtained title to a property contaminated with either bacterial or fungal organisms, the lender *now* clearly has the traditional tort duty to "act reasonably" in its ownership capacity. While most lenders will work to sell the property as quickly as practicable, lenders will typically maintain title to property for months while an appropriate buyer is found and documents can be negotiated. During this period of time, a lender must be vigilant to limit the exposure pathways of the fungal and bacterial

contamination to the general public, as well as professionals such as real estate agents, home inspectors, electricians, plumbers and carpenters, whom the lender may engage to place the property in saleable condition.

One option for the lender is to evaluate whether the mold contaminated property is marketable in its contaminated state. We anticipate that in all but the most unusual of circumstances, the property will not be marketable without remediation. If the lender does believe, however, that the property is marketable without remediation, there are some guidelines it should consider. A lender is well advised to quantify the nature and extent of the contamination *before* listing the property for sale. Fungal and bacterial contamination exists in nature, and many fungal and bacterial organisms are common and pose little if any health hazard. With fungal contamination in particular, there are several organisms which are known to cause health problems, especially in young children, which can lead to the creation of allergies, exasperation of asthma, and, in limited cases, severe allergic reactions. It is therefore *imperative* that a lender retain the services of a qualified environmental consultant who will undertake a limited sampling protocol of the residential home, or commercial building, and identify the nature and extent of any fungal or bacterial contamination *before* listing the property for sale. Once the nature and extent of the contamination is obtained, it is imperative that the lender provide *full* disclosure of the results of the sampling to any potential purchaser.

Once the potential purchaser is on notice of the fungal or bacterial condition, it is important that the negotiated purchase price for the property makes financial sense in light of the estimated cost

of remediating the fungal and bacterial contamination. The goal is for the bank to act in a commercially reasonable manner, to prevent any claim by any future purchaser or resident of the property that the bank was reckless in selling a property with a known fungal or bacterial contamination problem. If the economics of the deal do not make sense, it is more likely that a judge or jury will conclude that the bank “knew” that its purchaser had no intention of appropriately remediating the fungal or bacterial condition.

It is also important for the lender to obtain an iron clad indemnity from the purchaser, guaranteeing that all future liability arising from the property will be borne by the purchaser. This indemnity should include the obligation to defend against any claim brought by a third party arising out of the fungal or bacterial condition at the property. In most cases, the indemnity will provide the lender with sufficient economic protection to cover the cost of future disputes.

Any transaction must also include the express

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obligation for the purchaser *either* to remediate and/or to disclose the fungal condition to subsequent purchasers. Public awareness of toxic mold conditions is in its infancy, and federal and state legislation has yet to identify the obligations buyers and sellers have with regard to these conditions. For now, the fungal condition should be treated in the same manner that a seller would treat any known “latent” condition by fully

disclosing all information in its possession to the buyer. To the extent the lender has paid a consultant to evaluate the extent of fungal and bacterial contamination, the results of that investigation should be provided to any purchaser, and the contract of sale should require the purchaser to disclose the results of that report to future purchasers or tenants of the property.

Of course, the most protection a lender can obtain when faced with a significant fungal or bacterial condition is to *remediate* the condition *before* selling the property. In this way, the lender can control the quality of any remediation, and thereby limit any future liability. Unfortunately, addressing most conditions is rarely cheap. Mold problems have to be remediated in two stages. First, a competent environmental professional must be hired to quantify and clean up the mold or bacterial condition that exists at the property. Second, a determination must be made as to why the condition existed in the first place. The most common causes for mold and bacterial conditions are leaky roofs, leaky interior plumbing and poor waterproofing which permits outside water to seep in to the house through either the foundation, windows and door sills, etc. Remediating these construction defects is often tricky and expensive. Nevertheless, by fixing the problem itself, a lender achieves the dual benefit of (1) selling the property for a higher price and (2) dramatically reducing any future liability exposure.

Insurers and Third Parties

If the lender determines that remediation of the property is necessary, it should consider whether it has claims against others, either insurers or third parties, who may have liability for the mold conditions. Most loan agreements give the lender, upon default, the ability to prosecute all actions

involving the property. This provision allows the lender to step into the shoes of the borrower, thus assuming the claims of the borrower regarding the property, subject to any defenses that exist against the borrower. The lender should also make a clear record that the borrower is relinquishing to the lender all its claims relating to the mold contamination. The lender may then pursue the insurer and others without fear that the borrower will reappear to seek a portion of any recovery. These potential claims will, in appropriate circumstances, give the lender options for transferring some or all of the mold remediation costs to others and maximize its recovery of the value of the loan.

Conclusion

Fungal and bacterial conditions raise many tricky issues for lenders. Until legislatures and environmental agencies catch up with this condition, the best rule of thumb for any lender is to analyze each proposed action and ask oneself, am I acting “reasonably” under the circumstances? For now, that is the best any lender can do.

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