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feature article

Collateral DAMAGE

by Charles L Perry, Jr

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THE RECENT GOVERNMENT REPORT ON MOLD-RELATED HEALTH problems have confused a lot of people. The press coverage revealed how divided public impressions are of how mold affects human health. On the same day and based on the same health-related release, The Wall Street Journal's headline was "Indoor Mold Linked to Problems Such as Asthma and Coughing," yet The New York Times' headline announced "Panel Finds Mold in Buildings Is No Threat to Most People."

Neither of those stories truly impacts a lender's primary concern when it comes to mold. And that is, "Is my collateral's health impaired if mold is found?" The answer to that question is "Yes, it is."

Perception is reality, and if the perception is there is mold on site, then there are just too many other deals to finance for a lender to want to take on that kind of complication. This is especially true in today's market for several reasons. First, there is no longer any coverage for mold in homeowners and commercial property-casualty insurance-a lender's first line of defense-prior to the last two years.

Second, since that coverage is gone, that means your next alternative for a financial solution is litigation-which is one of the primary reasons lawsuits involving mold and real estate are being filed at the rate of 10 or more a day. That has been the case for the last three years. And who needs litigation if you're a lender simply seeking to be made whole by way of your rights to the collateral?

Finally, having just experienced a decade of environmental changes to lending policies having to do with issues such as asbestos, lead paint, leaking underground storage tanks and the rest, mold is unfortunately an altogether different enemy.

At least with those other environmental hazards, if you removed them you knew they were gone, and you and your borrower moved on. But unfortunately with mold that is absolutely not the case; in fact, it's not even close.

If mold is present and you pay to have a remediator remove it, given the right climate or water-soaked area of the building that can't be seen, give mold 48 hours and its back for another visit. And if the conditions are right, next year-how about another attack in another area of the building, and let's just add that it, too, is in an area that you'll not see until it's too late. The ugly cycle starts again.

All that said, this problem cries out for prevention. This is truly a problem you never want to have introduced to your collateral in the first place. So the best approach is to stop it before it starts.

While the scientific debate stumbles along over how mold affects physical health, there is no doubt whatsoever that mold affects the financial health of loan collateral in mortgage portfolios. The effects can be so bad, in fact, that the Mortgage Bankers Association (MBA) created a working group on mold. The group was charged with researching the issue, coming to conclusions and reporting back to the full MBA membership on suggested "smart practice guidelines" for mitigating or preferably eliminating the risk of mold contamination of commercial and residential properties. The group has assembled a substantial number of facts and recommendations but the work is not yet complete. The full report is scheduled to be presented and available at MBA's Commercial Real Estate Finance/Multifamily Housing Convention in February. This article offers a number of suggestions aimed at prevention that I think lenders should know about right away.

As a lender for 20 years and as a consultant on lenders' environmental issues for more than 12 years, I believe that unless we make changes with our new construction lending policies along with our policies for rehab, remodeling and remediation, the worst is yet to come. Some say the days of huge multimillion-dollar jury prizes in mold cases are over. This may be true for bad-faith claims between individuals and insurers. Those lawsuits were not really about mold in the first place, but more about bad faith later. However, mold liability lawsuits initiated by commercial and residential property owners against every imaginable stakeholder-lender, developer, builder, contractor, subcontractor, neighbor, neighbor's pet-are rising every single month.

Several sources estimate the average number of mold claims a day is now running at about 10-and that number could easily rise to 20 per day in the near term unless we change our building habits and our lending policies. This is especially true for every new site being built where a prevention approach could really help.

Yes, we live in a litigious society, but these lawsuits have spread across the country like, well, mold, because insurers in 43 states and the District of Columbia have underwritten exclusions in their standard property-casualty policies. The only other risk they have excluded across the board with this kind of speed is terrorism. Why? The Insurance Information Institute, New York, reports that carriers paid approximately $1.4 billion in mold-related claims in the United States in 2001 and in 2002 payouts rose to $3 billion. So, if you're a naysayer and don't believe that mold is a serious problem, then you don't believe what a bunch of intelligent folks in the insurance industry believe about the risk.

Lenders hold 80 percent of the risk on most properties (since borrowers generally invest 20 percent upfront). Therefore, on the issue of mold, given that insurers have fled the scene, lenders are standing in the open with nothing on but their birthday suits.

Understanding the "mold square"

The conditions under which mold occurs, according to an analysis developed by the University of Florida, require the existence of spores, moisture, a normal temperature range and the presence of a food source (i.e., cellulose-as in paper). Because temperatures, airborne spores and moisture are issues dealing with Mother Nature, the only truly controllable variable by means of a lender and/or borrower is the food source. The food source primarily includes products with organic content, which, by the way, account for approximately 80 percent of the surface area of a building. This is not rocket science; in fact, it's pretty basic-water plus organic material means mold. And as one science-based consultant tells me, "It means mold 100 percent of the time."

Organic products have been major factors in buildings and construction for decades: carpets, ceiling tiles, insulation and paper-faced wallboard. When it comes to products with organic content, there are only two kinds: those with mold and those that will have mold.

Mold myths

1) The myth still lingers that if you can control moisture, you can control mold. The fact of the matter is that humidity is here forever. If you live in or build and finance properties in certain parts of the country it will likely be worse, and accidents like broken pipes happen. Humans, with our four bathrooms and our dishwashers, emit more water in a day than is caused by poor construction. Water is a fact of life.

2) Remediation is "the" solution. Unfortunately, that is not true. As I've mentioned earlier, once mold has become visible and able to be remediated, it's too late. No matter what you do, unless you remove everything that might have caused the problem or "scraped the ground," as they say, or unless you've moved from Texas to Minneapolis to escape the humidity, then it will return.

Today's average cost of remediating mold in a 2,ooo-square-foot house or business is $40,000 or more, and that's just the first time around. Contrasting that jaw-dropping figure, you could spend no more than a few hundred dollars on preconstruction mold prevention on that same building and stand a very good chance that you'll not have to worry about mold contamination. One builder source who specializes in $1 million to $3 million houses on the East Coast, said, "The equivalent of making these homes mold resistant is probably the same as upgrading a sink and a light fixture in a bathroom." But I'll get back to prevention in a moment.

I'm not disparaging solid mold remediators; I'm just saying that there is a much better solution for the future and it lies in prevention, not in remediation.

3) Another myth involves inspections. A recent informal poll of MBA members showed that 75 percent of them performed a mold inspection for loan purchases and 53 percent performed a mold inspection for loan originations-which, generally speaking, is a good thing. However, the bigger issue is that a recent interview done with a number of remediators showed that more than 80 percent of them believed that a mold inspection only is productive and helpful if the mold is visible.

But beyond that, we have no standards to judge whether the mold present is above or below a certain standard. Imagine the complexity of attempting to set standards for, let's say, 100,000 types of mold and say 1 million different types of immune system reactions-it simply is not going to happen, and if I'm wrong, I'd love to see that grid.

This is unfortunate, because standards would help lenders a lot. In that same poll, 25 percent of lenders said that the lack of standards delayed loan closings. More than 20 percent said the lack of standards caused termination of loan applications.

4) "Mold accumulates within structures over long periods of time." Wrong. The majority of serious mold problems start before construction begins. The way in which building materials are stored at the warehouse, transported to the site and stored on site will often determine the probability of mold damage down the line. Because of leaky storage facilities and unsealed conditions on trucks and construction sites, building materials are often exposed to mold spores before a contractor puts a hammer to a nail.

The following are property types where mold is wreaking the most havoc.

Multifamily: In the same informal MBA member survey, respondents were asked for which property types they were likely to request a mold survey/assessment. A full 22 of 24 lenders said multifamily/apartment. The reason is simple. Imagine a homeowner, like the one in Texas who recently won several million dollars from an insurance company for mold damage. Now multiply that suit by say, 300, as in unit tenants. That is the risk level of multifamily collateral. If mold finds a home in the air vents, for example, every single occupant could be affected one way or another.

Hospitals/health-care centers/nursing homes: Next on the worry list based on findings from the same MBA member survey was the health-care sector (17 of 20 lenders). Obviously, the last place you want to find air-quality problems is in a hospital. The liability issues are massive because they are largely health-related.

Class-action lawsuits are engulfing borrowers. Financial pressure is also coming in the form of worker's compensation claims and extended disability leaves by employees. In addition, once mold takes hold, that institution's premiums for directors and officers (D&O) insurance and commercial general liability insurance skyrocket. By the way, most of those types of coverage also exclude any third-party coverage for mold-related claims and, more important, the insurers therefore have no duty to defend the insured-currently a very tenuous situation. These factors can decimate a borrower's ability to make loan payments, leaving the lender holding the bag. This is a whole new situation lenders have suddenly found themselves in.

Hotels and other hospitality structures: Several high-profile cases of mold in hotels have caused fleeing retail tenants, lawsuits and, in the case of one resort hotel in Hawaii, the closing of the building just months after it opened. Worse, the property is tainted. It's like the newfound mold equivalent of yesterday's mold problem-Legionnaire's Disease. If the hotel tries to reopen, occupancy rates may never recover because of the stigma. The likelihood of a lucrative resale or refinancing plummets. Again, the lender is exposed to 80 percent of that risk.

Affordable housing: "Affordable" means the properties are oftentimes older buildings with lower budgets for construction and maintenance. Because of this they are prone to have a higher likelihood of mold-related problems. For the record, these properties rank among the highest for litigation incidents involving mold suits and large settlements. The two major tenants of affordable housing-the elderly and the young-are in the highest-risk category for mold-related illnesses. Lenders simply cannot afford to have these kinds of liabilities looming. If remediation is necessary, the costs may be prohibitive. So you foreclose and knock down the building-not exactly what the lender had in mind when it made the loan, not to mention the fact that you've probably just added to your list of nonperforming loans to report.

I have not mentioned military housing and schools because the majority of mortgage lenders typically are not involved in the debt on those structures. However, bondholders beware: Problems in those two areas are rampant.

Lenders taking action

So now what do we do? There's got to be a pony in there somewhere. The most important issue to understand is that the opportunities for new construction, rehab, remodeling and remediation are substantially different than what they are for existing properties going through a renewal or refinancing or a sale as is.

Mortgage lenders actually have an opportunity to prevent the likelihood of mold in the future by setting specific new requirements in their lending guidelines-especially their construction lending guidelines, typically the tightest of all for mortgage lenders anyway. These lending guidelines should include the required use of mold-resistant building products, proper construction techniques and effective inspection regimes, especially inspections that take place while the building products lay on the ground at the very start of construction.

Many types of mold-resistant building materials have been developed or are currently in use: steel framing, foam insulation boards, sprayed insulation, unfaced fiberglass insulation, composite plastic panels and decking, glass curtain walls, concrete blocks and, most important, paperless wallboard-since, as I mentioned, more than 80 percent of the surface area of a building is its walls.

Wallboard is the most common element of any post-1950s building, and unfortunately the paper facing on the front and back of the board makes a great home for mold. Permanent mortgage lenders should require that construction loans be contingent on the use of paperless wallboard, which is sheathed with fiberglass rather than paper. These kinds of building products have recently been developed for the inside of buildings, a technology that has been universally accepted and extremely successful for the exterior of buildings for 20 years. To back that up, lenders should also require pre/during/post-project inspections that check for the presence of mold and mold-resistant products.

In other words, if you were to build a building of totally inert materials, such as fiberglass, aluminum and other man-made inorganic materials, and you built it wisely, then you probably would not have a mold problem. New construction can offer an opportunity for effective prevention measures unavailable to existing buildings.

On construction loans, a lender may be able to help prevent the mold problem, whereas a lender providing financing to existing properties may not have the same chance for controlling the presence of mold. However, think about it: A new construction loan today is an existing loan of tomorrow, one that will someday be refinanced or perhaps sold into the secondary market. What we're doing is trying to initiate change, start a movement, that someday soon could change the likelihood of mold filling up loan portfolios-and all it takes is that very tough change of habits.

Construction lenders have the same strong desire to protect the real estate. No one wants to be in the position where the borrower's financial status has been impaired, then to find out later that the collateral supporting the loan has also been impaired. If construction lenders-and certainly permanent lenders, since they are sitting on these loans for a much longer time-consider their position with respect to mold, especially in light of the lack of insurance coverage and increasing mold related litigation, then a number of opportunities with respect to new construction and related loans should be considered. Some are as follows:

Make changes to loan documents that require an inspection of building products prior to and during construction-both during the delivery process and during the construction process while being stored on-site.

Make changes to loan documents that require the use of mold-resistant building products wherever possible in the building or home. Be especially diligent for those property types yielding the most mold-liability potential today (i.e., multifamily properties, single-family homes, health-care facilities, schools, hotels/motels, etc.).

Make changes to loan documents that require an inspection of the construction process to see that both construction practices have been met or exceeded and that the mold-resistant building products required (i.e., no food source present) have in fact been used during construction.

Post-construction, require that an inspection be performed to verify the absence of mold before the permanent loan is funded.

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