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Insuring the Construction Project against Water Infiltration and Mold Contamination

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Before the owner undertakes any construction project, it must have appropriate property insurance. The owner must understand the nuances of applicable insurance coverage long before any damages occur during construction. If the insurance company seeks to avoid a coverage determination or otherwise declines coverage, counsel must steer the owner through the claims process and, if necessary, seek court ordered declaratory relief as to its policy rights and recover the costs of direct property damage and lost income.

As the construction site is prepared, foundations set, and the superstructure is built, no matter the extent of precautions, water and moisture will enter from the unfinished roof and sides of the structure. No matter how experienced the construction team, the reality of construction is that a building may not be watertight as the interior is being built. Water infiltrating the unfinished building has the potential for serious, unexpected future problems. Mold contamination, for example, caused by water infiltration, will require substantial repair and remediation work -- a very expensive process for the owner, requiring specialized environmental consultants to enter the premises and remediate. Remediation will inevitably extend the scheduled date of completion and thus delay the necessary

sign-offs required for a certificate of occupancy. The owner's income stream to pay interest and principal on construction financing will be delayed. Lost income means increased financing expenses, as well as months, or longer, with no cash flow. Delayed opening invites other problems, as prospective tenants may choose to terminate existing commitments for space in the building and look elsewhere.

This article surveys the proper insurance for the project allowing the owner to shift to the insurance company the costs of losses sustained to the property and lost income if water infiltration and mold contamination occur. The right insurance can protect the owner's investment from unexpected delays, business interruption, contamination and remediation costs. Even with the right insurance, however, the owner must have in place a project management system triggered immediately when such problems occur. This article also will address such a system.

The Right Insurance During Construction

The selection of the appropriate insurance for construction projects cannot be left to the insurance broker or agent, even if they have years of experience writing commercial property insurance. They cannot

know how courts interpret insurance forms when the insurer declines coverage, or otherwise delays providing a coverage determination.

The standard commercial property insurance for the owner includes the property coverage form, which obligates the insurance company to pay for direct physical loss or damage to covered property, caused by or resulting from a covered cause of loss -- defined as risks of direct physical loss, unless the loss is excluded in the policy. Builders risk coverage also is available to reimburse the direct physical loss during the construction project.¹ The builders risk form will protect the insured from loss of business income where the construction completion has been delayed by the covered cause of loss.

Mold claims present difficult problems for the owner. Mold spores can secrete enzymes that digest cellulose-based materials, such as sheetrock, wallpaper, paneling, hardwood flooring, insulation, carpeting, and paint. Property damage from mold is usually discovered only after structural components have been removed. As a result, determining the date when mold loss occurred can present serious difficulties, especially as it relates to providing timely notice of loss (*see infra*).

Counsel can assist the owner choose the right mold exclusion forms. In the industry's effort to put a lid on mold claims, the Insurance Service Organization (an industry umbrella organization that prepares insurance forms, known as the ISO) recently developed a new exclusion for mold. It protects the insurer, not the insured. Under the new form, damage resulting from mold is excluded. The earlier version, referred to as the "wear and tear" exclusion, better protects the insured, as it does not apply to mold arising from a sudden and accidental event that is otherwise covered, such as water damage.

Reporting the Loss

When water infiltration occurs during construction, the owner must promptly notify the carrier to avoid its later disclaimer of coverage based on late notice. New York law on prompt notice is draconian. The insured who delays providing the carrier with notice risks disclaimer, even if the insurance carrier is not prejudiced by the delay.² However, should the insured be late in providing notice to the carrier, the carrier can waive its late notice defense if it does not provide to the insured timely notice of disclaimer on that basis,³ or when it sends the insured a disclaimer letter, specifying certain grounds, but failing to specify late notice.⁴ The carrier's attempt to avoid this case law by sending out generalized "reservation of rights" letters, should constitute a waiver of its late notice defense.

Insurer's Practice After Notice

After reporting the loss to the carrier, the claims adjuster examines the damage. The insured is required to protect the damaged property, make available to the carrier all relevant records regarding the property loss and lost income, and otherwise cooperate with the carrier during the investigation of the claim. While such obligations may be relatively simple to identify, in practice when losses are sustained during construction, the issues become clouded for the carrier and insured. For example, if sheetrock is damaged by water infiltration, typically the builder will destroy the damaged material, so that mold spores and contaminants do not circulate through the project site and damage other structures or threaten the health of residents. This is especially a sensitive issue in construction of continuing care and educational facilities, and hospitals.

While destruction of such damaged property might technically violate policy

general conditions and constitute a basis for the carrier's declining coverage, it is unlikely that any court will uphold such a defense, because the relevant test -- were its actions reasonable under the circumstances -- would support such actions.

Assuming that the insured has not removed the damaged property or otherwise commenced its repair and remediation work, after the insured notifies the carrier of the loss, the adjuster typically visits the site, undertakes a "take off" to identify the required scope of work -- where the adjuster examines the damage to determine its extent, what must be replaced, and the cost. This is the typical scenario, but construction is not simple. Assuming the owner is unaware of any mold contamination or otherwise believes the water infiltration can be repaired by the builder, it may not notify the carrier and authorize the repair work. Later, when it becomes aware of a mold contamination problem, and then puts the carrier on notice, it will face the claim that, having already done the repair work, the insured is not entitled to coverage because the carrier could not do a "take off" or otherwise evaluate the property damage.

Business Interruption

When anticipating the potential loss to business income caused by water damage during construction, the owner should make certain that insurance includes business income coverage, permitting the insured to recover, in addition to lost income, all reasonable costs preparing and submitting the claim to the carrier. These costs include accountant's and attorney's fees. Accountants assemble financial information substantiating losses. Counsel will interpret the scope of the relevant policy and present the claim to fall within all relevant coverage provisions.

The "Guarantee" in Builder Risk Insurance

Insurance carriers may also attempt to limit their exposure for builders risk coverage during construction by declining coverage based on claimed terms of the contract between the contractor and owner. For example, a policy might include a provision that coverage for builders risk will not apply to any loss or damage covered under any "guarantee of any contractor". While the contract itself may provide that if the contractor defaults in performance of contract obligations with the owner, that provision should not be construed as a guarantee by the contractor. Unless there is a clear definition of the term "guarantee" in the policy, the legal principle -- construing the ambiguity against the carrier and in favor of the insured -- will apply.⁵

Avoiding Problems

The following procedures should be implemented to avoid subsequent coverage problems. First, a satisfactory reporting system for water damage must be in place. All construction personnel must regularly deliver any report of water damage to the owner. Upon receipt of such a report, the owner, in consultation with counsel, must determine whether, and when, to notify the insurer.

Second, it is essential that construction personnel understand how to report water damage. If there is a concern that mold has developed, that fact should be reported immediately to the owner so that appropriate professionals can examine the contaminated area and determine what remediation is appropriate. The insured should report this contamination to the carrier.

Third, preparation of the claim, including documentation to support cause of loss, extent of loss, repair, remediation, lost income, extra expenses, along with claim

data expenses, should be assigned to counsel. The document submitted to the carrier will be the key to the insured's recovering damages.

If the insured already has completed the repair work before notifying the carrier of the loss, the claim must be backed up by all relevant contractor invoices for labor and materials. The carrier will review the labor rates to determine if they are within the regional wage scales. Additionally, it will determine if the materials costs are reasonable in the region, and for the project. The carrier likely will hire forensic accountants to review all such invoices relating to property damage and lost income,⁶ and prepare schedules summarizing all underlying invoices to determine whether the costs are supported.

Finally, to effectively document the cause of loss and insured's damages, all invoices for the respective contractors and subcontractors must be retained, and all evidence of payment should be available for the carrier.

Conclusion

In the end, the only effective way to accomplish what expensive property coverage policies are designed to achieve is to prepare for water and mold damage before construction begins. Failure to be prepared to properly process the claim may result in the insured's loss of any value that such policies were designed to provide.

¹ A valuable textbook discussing relevant commercial property insurance forms is Commercial Property Risk Management and Insurance (7th edition), by Jerome Trupin and Arthur L. Flitner, published by Insurance Institute of America, which explains how insurance companies interpret coverage issues when a claim for property damage and lost income is submitted. The authors recently retained Mr. Trupin as an expert witness representing an owner, whose claim for recovery of lost business income and direct property losses during construction, was denied by the carrier. In the action brought in United States District Court for the Southern District of New York, the carrier settled, days before trial, paying the owner direct property losses and lost business income.

² E.g., Crucible Materials Corporation v. Aetna Casualty & Surety Company, 228 F.Supp2d 182, 193 (N.D.N.Y. 2001).

³ E.g., General Accident Insurance Group v. Cirucci, 46 N.Y.2d 862,864, 414 N.Y.S.2d 512,514 (1979).

⁴ E.g., State of New York v. Ambro Realty Corporation, 936 F.2d 1420, 1429-32 (2d Cir. 1991).

⁵ In the coverage action (footnote 1, supra), the Court refused to interpret the contractor guarantee exclusion of the builder risk form to relieve the carrier of its coverage obligation.

⁶ In evaluation of the lost business income component of the claim, the carrier's accountant will apply an expense variable to reduce significantly the recoverable lost income. This variable is described as that expense that typically would not continue to be incurred by the insured because of business interruption. The authors' experience deposing forensic accountants retained by the carrier in the coverage action described in footnote 1, supra, demonstrates that there is little literature guiding the forensic accountant as he identifies the "appropriate" expense variable. When the authors deposed the forensic accountant, he admitted that the "appropriate" expense variable was a "guess".