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Commercial values impacted by moldy misperceptions

It sounds like a set-up for a joke: What's black, green and can put you in the red? But the answer – toxic mold growing in your commercial property – is far from a laughing matter.

When the insurance industry was hit with so-called “toxic mold” claims in the 1990s, the response was clearly articulated exclusions and higher insurance premiums. So now the focus has shifted to the commercial real estate market.

One of the first commercial real estate mold “mega-suits” was in New York in late 2002, when real estate developer Richard Kramer filed suit against Zeckendorf Realty for \$2 billion. Kramer

alleged that faulty construction at 515 Park Ave. – billed as the world's most expensive residential building – had contributed to mold problems that made his wife and 3-year-old daughter gravely ill. The lawsuit resulted in multiple ongoing civil proceedings, and the resulting publicity negatively affected the market value of the property. More importantly, the suit seemed to foster

similar cases in other states.

That same year, mold infestation forced the closure of the \$95-million, 453-room Kalia Tower and 42,000-square-foot Waikiki Spa at the Hilton Hawaiian Village Hotel. The Hilton Resort sued the designer, engineers and sub-contractors over the mold growth and underlying defects at the spa. Reports indicate that mold remediation cost Hilton \$55 million. But that is only a fraction of the total cost, as the Kalia Tower lost significant revenue from the closure of the guest rooms, thereby reducing the value of the hotel to its owner.

Mold claims are vigorously litigated because remediation is often difficult and expensive. Repairs not only involve actual cleaning up mold, but also fixing the damage inflicted by inspectors who must punch holes in walls and rip up floors to determine the extent of the infestation. As a result, it is not uncommon to see remediation bills that far exceed – perhaps by two or three times – the property's fair market value.

The urgency of remediation, however, is open to debate. Mold could put those with significantly weakened immune systems, such as HIV/AIDS patients or people taking anti-cancer medication, at risk to acquire pneumonia or other systemic infections. But to date, there has been no well-supported scientific evidence proving popular claims that mold exposure causes brain damage or birth defects.

Perhaps a more pressing concern is in protecting the commercial real estate value. Property value is often reduced secondary to

the perceived mold contamination and the remediation process. When the mold is remediated, the value of the real estate, whether commercial or residential, is reduced, suffering what is termed a “diminution in value.”

For commercial real estate, if the property is forced to close during toxic mold remediation, the company faces a potentially extended period of lost income. As a result, from an appraisal context, the value of the property will be reduced in a discounted cash flow analysis.

Critical is the determination of property value. Whether it's the plaintiff, owner or insurance company, all sides must be able to appraise the property logically in order to quantify damages accurately.

The appraisal process is an elaborate function of finance, accounting and mathematics, but is not an exact science. There are three approaches to determining the value of real estate: Sales comparison, income capitalization and cost. The appraiser uses all three to determine the final value of commercial real estate.

When dealing with a toxic mold claim asserting physical injury (those not including bad faith claims,) a practical “damages model” possesses three components that should be considered: Physical injury, remediation costs and “diminution in value.”

Injury and remediation may be difficult to establish. The degree of success of a physical injury claim will be directly tied to the evidentiary standards of the state or jurisdiction. And, because remediation costs vary

wildly from one case to the next, it is important to establish that the work done was actually necessary to rehabilitate the property.

Alternatively, damages under a theory of “diminution in value” may exist if the revenue stream of the building is lost during the remediation process. Thus, the actual market value of the asset would be reduced. The damages under this theory could be significant if the commercial asset “spins-off” a lot of cash on an annualized basis.

Because buildings are not typically considered a “product,” a theory of strict liability is usually not available as a means of recovery. However, “diminution in value” along with negligence, fraud, breach of contract and bad faith are usually viable theories of recovery in a typical mold case. To date, the most costly mold cases have been directed toward insurance companies and the way the claims were handled.

The public's perception of mold can negatively impact property values. In the real world, perception becomes everything, and the mental and physical frustrations associated with the management and remediation of a mold infestation certainly compound the problem of diminishing property values.

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