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**WHAT SURETIES SHOULD KNOW ABOUT MOLD DAMAGE
CLAIMS
(OR, THE FUNGUS AMONG US)**

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INTRODUCTION

Man and Mold have co-existed since the beginning of time, and we often have blamed molds, rightly or wrongly, for causing harm. For example, the Egyptians blamed mold for causing plagues, and the Bible outlines a process for mold remediation of a home in order to avoid the spread of leprosy.¹ More recently, the Center for Disease Control and Prevention of the United States Department of Health and Human Services ("CDC") confirmed that molds cause infections in hospital settings, cancers in agricultural workers, and allergic reactions.² However, it is only during the last several years that mold has become a judicial issue.

During the last decade insurers, property owners and contractors increasingly have faced the threat of liability for property damage and personal injury claims related to the growth of, and alleged exposures to, molds, mildew, and other forms of naturally occurring fungi or organisms within the "completed work". Historically, claims for remediation of such conditions were treated as part of the cost of repair of water damage or flood claims, covered by property or flood insurance.³

However, this accepted practice has changed dramatically since a Texas jury in 2001 awarded a thirty-two (32) million dollar verdict to a homeowner against her property insurer (a subsidiary of Farmers Insurance) for its delay in remediating the mold found in her home.⁴ In the two years immediately following that verdict, which we will refer to as the "*Ballard* decision," the Texas Department of Insurance's statistics showed that mold-related claims jumped six fold.⁵ In 2000, mold claims generated claim losses of \$151 million,

which jumped to \$853 million for the year 2001.⁶ The appellate court that reviewed the Ballard decision stated:

“In 2001, ‘Farmers registered more than 12,000 mold claims, up from 12 in 1999. Allstate says its monthly tally of such claims climbed to 1,000 in the first three months of this year, up from 40 a year ago.’”⁷

Nationally, there are now over 10,000 mold-related lawsuits, spanning the state courts of California, Florida, Delaware, New York, Oregon, South Carolina, and Wisconsin, as well as Texas; though the problem is most acute in Texas.⁸ Although Texas has eight (8%) of the country’s population, by 2002 it had seventy-five (75%) percent of all mold claims.⁹

This predicament led to an insurance availability crisis, which the Texas legislature dealt with during its last session.¹⁰ In addition to Texas, state legislatures in California and New York, as well as Congress and federal agencies, are attempting to address the mold issue.¹¹ The actions taken by the courts, legislatures, and agencies have created a mixed response as of today. For instance, the business of mold remediation is now subject to licensing in the State of Texas.¹² While tort reform legislation, scientific studies, and judicial rulings, combined with aggressive claims handling, have demoralized, for the moment, the plaintiff’s bar from pursuing personal-injury claims related to mold exposure, property damage claims are still a significant risk even though the availability of typical property insurance coverage for property damage related to mold growth has been severely limited.¹³

The combined effect from aggressive claims handling, increased litigation risks, and building and material designs that potentially increase the amount of natural moisture trapped within the building in temperate climates such as found along the Gulf Coast of the United States, have led to a re-evaluation of the nature, cause, and treatment of mold conditions within the scheme of risk allocation. In essence, these conditions are no longer being viewed by insurers as merely the effect of fortuities such as water penetration or flood damage, but are seen as separate and distinct conditions that call for separate underwriting for new and more expensive coverage, exclusions from basic property insurance coverage, and more rigid enforcement of existing exclusions in certain policies.¹⁴ The effect of this change in approach by the insurance carriers has been to shift much of the risk of loss to the owners and contractors just as the scope and expense of such potential claims have skyrocketed.

In this environment, it is foreseeable that owners will attempt to shift this risk of loss to the contractor, because the owners may perceive that the contractor is better able to spread the risk among the subcontractors, as well as the subcontractors’ carriers. Moreover, there is an emerging trend in commercial construction to look to the contractor’s performance-bond surety to cover costs for remediation. It is this last potentiality that is the focus of this paper. As this is a recent phenomena, there is little guidance from the law as to how attempts to shift the risk of mold claims to the surety will be handled by the courts, but the only known published opinion on this subject upheld the imposition of liability on the performance-bond sureties. *Centex-Rooney Construction Co. v. Martin County*, 706 So.2d 20 (Fla. Dist. Ct. App. 1998).¹⁵ This paper will focus on established principles, rulings in analogous situations, the *Centex* opinion and other recent rulings, recent statutory

changes, and attempts to apply them to performance-bond sureties. These principles are analyzed in the context of the current AIA contract forms, typical bond and insurance language, and typical provisions in the surety's indemnity agreements.

THE NATURE OF THE RISK

When mold is found, the cost and scope of remediation can be substantial. Moreover, if remediation and repair is not started quickly, the mold can spread, increasing the potential damage and cost of repair. In fact, contrary to the historical risks to which performance-bond sureties have been exposed, costs of mold remediation and repairs increase with the completion rate of the project, and with the passage of time. For example, a recently documented case against a surety for remediation ended by the sureties paying a \$35,000,000.00 settlement.¹⁶ Moreover, there are consequential damages that may arise from health and safety issues that are being raised in many of the mold-related lawsuits.¹⁷

The following is a published description of the factual basis for the *Ballard* decision against Farmers Insurance:

The plaintiffs resided in a large home (with a fair market value of approximately \$3,000,000), which was insured by the defendant Farmers Insurance. In late 1998, the plaintiffs noticed water damage to the hard wood flooring throughout certain areas of the home. Unsure of the cause of the damage, the plaintiffs hired a flooring contractor to attempt diagnosis of the problem and, if possible, correct it. On December 17, 1998, the plaintiffs submitted a timely claim for their water-damaged wood floor.

The plaintiffs testified that in April 1999, they were advised that the water damage to the home had created an environment for the development of a dangerous black mold, which can in some cases be life- or health-threatening. Upon obtaining several estimates to repair the problem and upon examination of their homeowners' policy, the plaintiffs determined that the damage was a covered item, prompting their submitting a timely and lawful insurance claim to their insurance carrier. The defendant insurance carrier advised that prior to approving the claim, an investigation into the matter would be required.

The plaintiffs filed the claim in mid-December 1998. The plaintiffs contended that the defendant insurance company, while conducting numerous inspections of the damage, delayed until mid-February any attempted resolution of the claim. The plaintiffs alleged that when the defendant did investigate, its testing was limited to a below-the-foundation test, and that the defendant's investigators failed to ensure the integrity of the

plumbing. The plaintiffs contended that the defendant failed to perform a complete plumbing test of the premises to rule out leaks in the internal plumbing system as the source of the problem, despite written representation to the contrary to the insured. It was not until late February that the defendant agreed that the repair was covered. By that time, however, additional damage, which the plaintiffs alleged was caused by the defendant's delay, had been reported. The problem continued to escalate significantly, rendering the initial claim filed by the plaintiffs to be incomplete.

The plaintiffs testified that due to the worsening problems and the defendant's delay, the plaintiffs were forced to file a second claim, with supportive documents indicating significantly greater damage and higher cost of repair. The defendant continued to put off payment of the claim and instead, conveyed the need to undertake additional investigation. The plaintiff contended that this unnecessarily caused further delay, preventing the plaintiffs from eradicating the mold and repairing the condition while this was still possible. By the time the defendant's investigation was concluded, the mold had completely permeated the residence, leaving the plaintiffs with no alternative but to demolish the structure and rebuild, according to the plaintiff's experts.

The defendant insurer denied acting in bad faith, asserting that the case was timely investigated and that the type of mold and the source exacerbated the difficulties. The defendant maintained that the investigation performed was appropriate and that reasonable inspections to the plumbing system were made.

The policy limits were not offered by the defendant until November of 2000, after the appraisal of damages was calculated at over \$1,800,000 in damages....

The jury found for the plaintiffs and returned a verdict of \$32,000,000, including \$12,500,000 in punitive damages.¹⁸

In addition to the potential liability for owners and carriers related to the cost of repair, the economic impact to the property owner of the damage can last long after the remediation is completed. Even with complete remediation, obtaining subsequent property insurance coverage may be difficult and expensive.¹⁹ Moreover, the mold and remediation would have to be disclosed in any subsequent marketing of the property, thereby foreseeably reducing the property's market value. Finally, it is important to remember that the ultimate liability alleged against Farmers, and upheld by the appellate courts, was based on Farmer's extra-contractual duties.²⁰

Now imagine the “*Ballard*” scenario described above arising during the punch-list or warranty phases of a construction contract for a new school, a courthouse or a professional office building. The potential liability for the party holding the bag—the insurer, the owner, or the contractor—could equal or exceed the original contract price to construct the building. It is into this mess that the surety is usually injected. In fact, performance-bond sureties found themselves liable for \$8,800,000.00 in actual damages and \$5,411,156.00 in prejudgment interest in *Centex* under the following facts outlined in the Court’s opinion:

. . . Centex-Rooney Construction, Inc. (“Centex”) entered into a construction management agreement with the County to serve as the construction manager for the entire project. Centex and the other appellants, Seaboard Surety Company, St. Paul Fire & Marine Insurance Company, and the American Insurance Company (collectively “the Sureties”), jointly issued a performance bond and a payment bond to the County, jointly and severally binding themselves to ensure the proper performance of the construction management agreement. Centex also assumed complete oversight and control of the project, including responsibility for the selection of all subcontractors as well as the supervision, coordination, management, and inspection of their work.

Centex retained several trade contractors to perform various aspects of the construction, and the courthouse complex was certified substantially complete on December 12, 1988. Following its occupation of the courthouse and office building in early 1989, the County made several complaints to Centex about window and exterior wall leaks in these buildings, mold growth and excessive humidity. Centex’s own employees acknowledged and documented water infiltration through the exterior synthetic hardcoat systems (“EIFS system”), as a result of defective installation, which led to leaks and resultant mold growth in the buildings. An investigation also revealed several problems with the buildings’ heating, ventilation and air conditioning (“HVAC”) systems. In addition, the County received several complaints of health problems from the buildings’ occupants and visitors, and approximately twenty-five percent of the occupants evacuated the buildings before December of 1992. Concerned with the health issues, the County retained an environmental firm to perform tests to identify the potential causes of the indoor air quality problems and engaged an engineering consultant to conduct a complete analysis of their HVAC systems. Although the County took several measures to improve the buildings’ air quality and repair the leaks, the humidity problems remained unresolved.

...

On December 8, 1992, on its own initiative, the advisory committee voted in favor of evacuating the courthouse and office building. The committee relied upon information obtained from Dr. Hodgson and Dr. Morey in making its decision but did not receive any specific directive to evacuate from them. The committee members did not believe that they could, in good faith and good conscience, ask the County's employees, the litigants, the attorneys, and the general public to enter the buildings under the existing conditions. This evacuation required the relocation of all County employees from all these buildings to remote work sites. The County hired a coordinator for the remediation of the buildings, an engineering firm to advise on building repair, and an environmental firm to assist with removal of the molds.

...

The County subsequently engaged a remediation firm and instructed it initially to remove dry wall and outer covering in only specified contaminated areas of the courthouse and office building. However, as the rough walls were exposed, there was more visible mold and water damage than previously anticipated, requiring extensive demolition. Sixty to sixty-five percent of the exterior walls had visible mold on them. During this procedure, the County became aware of a multitude of hidden and dangerous structural and electrical defects, which substantially expanded the scope of the remediation process and increased the cost for redesign, reconstruction, and relocation.

...

These defects included the absence of necessary expansion joints in the EIFS system; and inadequate number and improper spacing of EIFS system fasteners; severe rust and water damage of metal studs, fasteners, and other building components; the inadequate attachment of multistory glass curtain walls; numerous cuts in the curtain wall frames; improper window glass and frame installation; drainage system defects; and over 1,200 potential electrical system defects.²¹

The admissibility of mold-related "scientific" evidence is an unsettled issue. The *Centex* Court upheld the admissibility of "scientific" evidence alleging a link between mold exposure and health problems, under Florida's evidentiary law that is less rigorous than the federal standard under the *Daubert* line of cases, which many state courts have adopted.²²

However, most courts in states, such as Texas, that have adopted the *Daubert* standard have denied the admissibility of such evidence to date.²³ These decisions are supported by the current findings of the CDC, which found no currently supportable link between exposure to indoor molds and the ailments claimed by most plaintiffs: pulmonary hemorrhage, memory loss, and lethargy.²⁴

RISK ALLOCATION UNDER THE TERMS OF THE CONTRACT (AND THE BOND)

Because there is no state or federal law specifically addressing bond coverage for this type of claim, the scope of potential liability of the surety under the performance bond for mold claims will be governed by the four corners of the underlying contract and the four corners of the bond.

The basic terms of the standard AIA form general contract incorporate a reasoned scheme of risk allocation for property damage or personal injuries between the owner and the general contractor, which is dependent on the availability of adequate insurance.²⁵ The methods of risk allocation include the creation of general obligations, indemnities, insurance and bond procurement, and waivers of subrogation rights. Generally, these methods shift to the owner the risks from site conditions, hazardous materials, property damage, loss of use of the property, and (in some instances) the costs of insurance obligations placed on the contractor.²⁶ In return, the contractor generally accepts the risks for premature, insufficient, incorrect, incomplete, and unsafe work.²⁷ Because the parties normally contemplate the availability of insurance to cover many of these potential risks, the AIA scheme generally limits both parties' exposure to damages from these risks in excess of insurance coverage. This limitation is achieved through express waivers of subrogation contained in the AIA form contract.²⁸ Courts have found that such waivers given to the contractor apply to the contractor's surety.²⁹

It is not uncommon for the owner and the contractor to vary their contract terms from the AIA form. Often these changes relieve the parties from obligations to obtain certain types of insurance, or allocate the risks differently. *Moreover, the parties often limit the waiver to actual proceeds received from the insurer for the claim, or delete the waiver provisions entirely, thereby signaling that the parties will remain directly liable for some or all of the risks regardless of whether either party obtains appropriate insurance coverage.*

The types of insurance policies that normally are contemplated by the parties include the following:

1. Comprehensive General Liability (CGL)—Contractor, and subcontractors;
2. CGL loss payee, also insured, additional insured provisions—subcontractors;
3. Builder's Risk—Contractor, and subcontractors;
4. Completed Operations—Contractor, and subcontractors;
5. Auto—Contractor, and subcontractors;
6. Workers Compensation, A and B—Contractor, and subcontractors;
7. Excess and/or Umbrella—Contractor, and subcontractors;
8. Loss of Use/Business interruption—Owner;

9. "All risk" Property—Owner, or contractor at owner's expense; and
10. Other property—Owner.

If each of these policies were procured by the proper parties for each project, most of the risks faced by the owner and contractor would be covered, theoretically, by insurance. Such coverage, coupled with broad subrogation waivers, would virtually end our analysis, because there would be little risk of loss to the surety from property damage claims. However, few projects can boast this much coverage, because the parties rarely procure each of these policies due to the premium expense involved, and (as noted above) the parties often vary the insurance and waiver terms of the contract. Moreover, the insurance industry has limited the scope of coverage of many of these policies by excluding certain matters from coverage.³⁰ Liability from exposure or damage from asbestos, pollution, and hazardous materials are among the matters commonly excluded from the coverage of these policies, so that coverage is either unavailable for these risks, or it must be obtained through payment of an extra premium for another policy or rider.³¹

Recent changes in underwriting and claims-handling practices by insurers have limited the traditional available insurance coverage. When these types of claims first arose in the early 1990's, the few courts that addressed the issue found coverage under property insurance policies, noting that the growth of such organisms was not an intended consequence of the construction process, and, therefore, met the "fortuity" test to constitute a covered occurrence under the policy.³² Moreover, pollution exclusions were narrowly construed to cover "unnatural" materials or pollutants: because fungus and other living organisms were natural substances, they could not be pollutants.³³ However, as the number of claims have exploded they are being denied for the reasons that they do not constitute an "occurrence" under the policy, notice of the claim is untimely, or the claims are excluded from coverage under existing exclusions (including the "pollution" exclusion). Courts, recognizing the rapid increase of mold claims, may become more receptive to these arguments.³⁴

In the current underwriting process insurers are writing new, specific exclusions for mold, fungus and other naturally occurring organisms, and are adding "mold" to the definition of "pollution" to conclusively bring mold within the "pollution" exclusion.³⁵ These new exclusions will apply to future claims. Examples of these new terms are contained in the Appendix. In tandem with the new exclusions, insurers are offering specific mold coverage for an additional premium, similar to the approach taken to cover pollution-related claims. In fact, adding mold to the definition of "pollution" is allowing carriers to include mold coverage under new pollution legal liability ("PLL") and contractor's pollution liability ("CPL") policies for extra premiums and smaller policy limits.³⁶

The combined effect of the claims-handling under current policies and the new language and premiums for future policies will create another gap in coverage available to the owner and contractor. Specifically, even if the owner has and will purchase property insurance to cover "all risks", and the contractor has and will obtain CGL coverage, including completed operations, they may find that their carriers will contend that some of the most costly effects of water penetration damage to the construction project will not be covered.

In this environment it will be increasingly likely that owners will resist incorporating broad subrogation waivers into the contract. To the extent that insurance cannot be procured for a reasonable price, owners will be reluctant to relieve contractors of any of the risk of loss from mold conditions.

As a result, foreseeable gaps in coverage are emerging that will change the actual risk allocation under the four corners of the contract. Depending on the scope of the waivers of subrogation contained in the AIA form contract, the owner and contractor may have no recourse but to hold each other responsible for contribution claims made for property damage or personal injury arising out of mold infestation caused by water penetration during the construction or warranty phases of the project. To the extent that the contractor remains at risk for these claims, so may the surety.

RISK TO THE SURETY FROM THE COVERAGE GAPS

Obviously, the surety's potential risk arises when the scope of its obligations under the performance bond overlaps one or more of the potential gaps in insurance coverage, and the contractor's liability has not been waived, or expressly shifted to the Owner. Without such limitations on the contractor's liability, the general rule is that the liability of the surety on a performance bond is co-extensive with the liability of the principal, subject only to the express terms and conditions of the bond.³⁷ Applying this rule, courts have found that, where the principal remains responsible for property damage claims under the contract, the performance-bond surety also may be responsible for such claims.³⁸ Therefore, there already exists a general legal framework within which a surety may be held responsible for property damage claims related to mold.

The *Centex* decision makes some sense when read in light of this general framework. The sureties were found joint and severally liable with the principal for the property damage caused by the principal's breach of contract.³⁹ There is no discussion about whether the claim was covered or excluded by the principal's insurer, or whether there were any waivers in the contract. However, assuming that coverage was excluded, the claim exceeded insurance coverage, and/or there were no waivers, *Centex* is a natural extension of the general principle just discussed.

If the principal is responsible under the contract for property damage claims that could include mold infestation, *the key limitation on the surety's liability would be the express terms and conditions of the bond*. First, the cause of the water penetration should be within the control or scope of work of the principal. To the extent that water penetration and mold growth arose from faulty design or selection of materials by the architect, the surety could argue that some or all of the damage is outside the coverage of the bond (in fact, this was successfully argued in *Centex* to obtain a \$2 million set-off).⁴⁰ Moreover, if the responsibility for the protection of the site from water penetration from storms or flooding is the owner's, the resulting damage is arguably outside the scope of coverage under the bond. Additionally, if the water penetration occurred prior to the commencement date under the contract, as might be the case if the project involves a renovation of an existing building, the resulting mold damage should not be covered by the bond, unless, of course, the control included remediation work.

Second, the water penetration and mold growth may arise after the completion of the project and the expiration of the warranty period. Under this scenario the surety may argue that the obligations under the performance bond are extinguished and void, that the applicable limitations for claims expressed in the bond has expired, or that an applicable statutory limitations period has expired. Many states prescribe limitations for suit on performance bonds issued in connection with public works. However, outside this context, if no special language limiting the time period for claims is contained in the bond, the normal limitations period under state law will apply. These limitations periods can last up to six years (e.g., Mississippi) and may not accrue until the defect is discovered (which, in the case of latent defects such as mold infestation, can extend the actual limitations period for years).⁴¹ In *Centex*, the bond contained no special limiting language, so the limitations period was governed by the statutory 5-year period.⁴²

Third, other typical defenses generally available to the surety may be applicable: lack of timely and proper notice; lack of cooperation by the obligee; overpayment to the principal after knowledge of the condition; voluntary payments by an insurance carrier when the claim would otherwise be outside the policy's coverage; the limitation of responsibility to the penal sum of the bond; and equitable subrogation. Any or all of these defenses may be available and should be raised when appropriate. In fact, equitable subrogation may be a key issue. In the event the owner has applicable insurance coverage, but it is inadequate to pay the entire claim and/or there is no waiver in the contract in favor of the principal, the surety should claim a superior right to the proceeds of the insurance to apply them as first dollars to the remediation and repair costs.

Remember, though, that under the current legal and economic climate, mold infestation will be remediated and someone will have to pay for it. Moreover, as shown by the *Ballard* decision, *the time period for the affected parties to assess their relative legal positions will be compressed in order to mitigate the damage from a growing and spreading organism*. As discussed below, these concerns may lead the surety to take certain steps under a reservation of rights before a final decision on coverage is made.

HOW A CLAIM MIGHT ARISE

Spores of fungi, including mold, exist virtually everywhere. They feed on carbon-based materials, including wood, which may be incorporated into a job site. The key catalyst for mold growth is the presence of substantial moisture for a period of time. The focus in mold claims is on active mold growth caused by water penetration over at least a 24-hour period.⁴³

A typical mold claim arises when an owner finds active growth behind walls; in an attic or crawl space, or equipment room; or underneath carpet or flooring, related to the fixing of a water leak. The source of the leak can be internal to the building, such as a defective pipe or HVAC system, or external, such as a defect in the roof, window or building envelope systems.

On a construction site, a claim could arise under these, among other, scenarios:

1. Either a storm, or a flood, occurs at the work site during construction, penetrating the contractor's (or subcontractors') work with water;
2. Defective materials are incorporated into the site, causing water penetration into work already completed;
3. A person is exposed at the work site to mold and becomes ill; or
4. Workers at the site uncover mold and refuse to work in the area until it is remediated.

For completed work, claims could arise under the following possible scenarios:

1. Within the warranty period after completion and occupation, carpet in the building is infested with mold;
2. Within the same time period, employees of the company that is leasing the building complain of headaches, allergies, and respiratory ailments, loosely diagnosed as "sick building syndrome";
3. Within the same time period, leaks are uncovered in the window treatments, and mold is found on the interior window frames and adjoining drywall; or
4. Mold is found in the interior of the building near areas of collected condensation from the HVAC units.

For projects where the surety has stepped-in under a Takeover Agreement, claims could arise under the following scenarios:

1. Mold is found during the performance of the Takeover Agreement;
2. Mold is found during the warranty period after the surety has completed work; or
3. Mold was remediated under the Takeover Agreement, but reappears during the warranty period.

After the occurrence of any of these issues, a claim is made by or to the owner or its insurance carrier, and the owner or its carrier sends a notice and demand to the surety to remediate the mold and repair the damage.

STEPS SURETY SHOULD CONSIDER UPON RECEIVING NOTICE AND DEMAND FROM THE OWNER UNDER THE PERFORMANCE BOND

Several concerns should arise from the surety's receipt of the notice and demand from the owner. Each of these concerns must be dealt with soon after the receipt of the notice in order to minimize the surety's potential exposure to a mold claim risk. These concerns include the following:

1. Has the bond obligation been properly triggered?
2. Is the issue raised by the owner within the scope of the bond?
3. Is the issue specifically excluded by the language of the bond?
4. Has the owner taken any action that waives coverage under the bond?
5. Does the principal have any defenses to the owner's claims or actions?
6. What is the status of the project?
7. How much of the contractor's work still needs to be performed?
8. How much money is left in the contract and retainage?
9. What is the condition of the work site while the surety is investigating the claim?
10. What action, if any, should the surety take, under a reservation of rights, to mitigate any potential bond claim?

The first eight of these questions are universally asked by the surety upon receipt of the notice and demand. Of these, the question of "trigger" could become important, especially during the warranty period. Under the seminal case, *L&A Contracting Co. v. Southern Concrete Services, Inc.*, the sureties' obligation is triggered only if the principal is in default, and the default has been declared.⁴⁴ If the surety acts to intervene before both events have occurred, it could incur tort liability to the principal.⁴⁵ During the warranty period, there is no real opportunity for the principal to be in default, or for the obligee to declare a default, so the surety must be careful in determining whether and when its obligation under the bond may be triggered. The surety can protect itself, to some extent, by requiring language in the general indemnity agreement that allows it to intervene without a declaration of default if mold growth is suspected.⁴⁶

Otherwise, the last two questions should be the focus of the surety's concern, because of the potential for mold claims (and especially if the presence of mold is a reason for the notice and demand). Current literature on the growth of mold, mildew and other fungi state that precautions taken within the first 24–48 hours after exposure of materials to moisture can protect the property from developing fungus.⁴⁷ In partial recognition of these

facts, legislation now pending before the Texas House of Representatives would require water-related insurance claims to be handled within 24-hours of the receipt of the claim by the insurer.⁴⁸ *To the extent mold is not an issue raised in the notice to the surety, the surety should still satisfy itself that the owner and the principal have taken the appropriate steps to protect the site from water penetration until the surety has completed its investigation. If neither party takes such steps, the surety should consider taking such steps under a reservation of rights.* An example of a reservation of rights letter that a surety could consider sending to the obligee is contained in the Appendix.

During the investigation, the condition of the work already completed should be analyzed to determine whether, and to what extent, the materials incorporated into the work have been exposed to excessive moisture during construction, and whether there is any detectable mold infestation. Contractors and testing agencies are available to conduct tests to determine moisture penetration, humidity levels, and active mold growth.⁴⁹ If active mold is found, the surety should determine what steps must be taken to stop the mold from growing and either demand that such steps be taken by the owner, or take such steps under a reservation of rights.

In order to mitigate any potential exposure to mold claims under the bond, the surety should determine the potential insurance coverage available to the owner, architect, engineer, contractor/principal, subcontractors and suppliers. To do this, the surety should demand from the owner and the contractor copies of all certificates of insurance applicable to the project. Once the appropriate carriers have been identified, the surety should demand that the carriers be placed on notice and given an opportunity to investigate. The opportunity to investigate is important to avoid sanctions, tort claims or adverse jury instructions based on allegations of destruction (“spoliation”) of evidence.⁵⁰ Unless or until all the appropriate parties have had an opportunity to investigate, thorough photographs should be taken of the affected areas and materials, and any removed materials should be preserved for analysis.

STEPS SURETY SHOULD CONSIDER IN THE FUTURE DURING THE UNDERWRITING PROCESS

The purpose of the performance bond is to secure completion of the contractor's obligation to provide the owner with a completed project pursuant to the performance criteria in the contract, and to secure the contractor's warranty obligation. In order to protect the surety from any ambiguity in the future as to whether mold claims that arise during the completion or warranty phases come within the coverage of the bond, the surety should consider taking one or more of the following steps, whenever it is possible:

Determine whether the Contractor has proper procedures in place for giving initial scrutiny to the sufficiency of the project designs for ventilation and moisture control, for keeping the risk of loss for faulty design on the owner and design professionals, and for educating its employees and subcontractors in mold avoidance techniques (similar to safety meetings and procedures implemented at the site during construction)⁵¹;

11. Analyze the Contractor's insurance coverage to determine the extent of mold coverage or exclusions, in order to properly evaluate the potential risk inherent in bonding the Contractor (an example of such a provision is provided in the Appendix);
12. Incorporate, if possible, into the express terms of the bond a term that excludes coverage for mold, or similar claims, that is similar to the exclusionary language used by the insurance industry (an example of such a provision is provided in the Appendix);
13. Incorporate, if possible, into the express terms of the general indemnity agreement, a term that allows the surety flexibility to intervene prior to a default if the development of mold is suspected, but without obligating them to do so (an example of such a provision is provided in the Appendix);
14. Thoroughly review and approve the contract language and insurance coverage actually procured by the parties to assess the risks accepted and covered by the parties in order to try to minimize the gaps in coverage before a bond is issued; and/or
15. Consider requiring the Owner and/or Contractor to release the surety from mold claims, and include the Surety as an additional insured on the policies providing mold coverage (an example of such a provision is provided in the Appendix).

These suggestions will, of course, necessitate greater underwriting vigilance. In the case of Public Works, as most contractor's are required to "bid to the form", lobbying efforts will have to be undertaken to deal with the exposure in some equitable fashion.

CONCLUSION

Especially in the climate found along the Gulf Coast, the presence of mold in buildings is almost a fact of life. Although the lack of a scientific link between mold exposure and harm to human health, coupled with aggressive insurance industry and governmental action, has led to a decrease in new personal-injury claims, the risk of property damage claims still exist. Because of the cost of remediation, and of the potential effect disclosure of mold infestation will have on the market value of the property, owners and insurers will try to shift the economic risks related to remediation and repair to third parties, such as contractors. In other words, the "fungus among us" has arrived at the surety claims office, and increased speed and greater diligence will be required to avoid significantly higher claims exposure. Likewise, underwriters now have something new to look out for, requiring the development and implementation of increased bond form and contract controls. To avoid the tremendous possible additional exposure mold claims represent, the industry must develop a consensus on possible legislation and other lobbying policies and efforts, given this exposure has not been contemplated in the current and accepted rating of bond premiums.⁵²

- ¹ See, generally, 114 A.L.R. 5 397, n.4-6; (2003-04); Jarman-Felstiner, Comment, *Mold is Gold: But, Will it be the Next Asbestos* 30 Pepp. L. Rev. 529 (2003); Leviticus, Chapter 14, verses 33-57.
- ² Redd, Stephen C., M.D., *State of the Science on Molds and Human Health*, Centers for Disease Control and Prevention, U.S. Department of Health and Human Services, p.2 (July 18, 2002).
- ³ See, e.g., *Donald v. Urban Land, Inc.*, 564 N.W.2d 728 (Wis. 1997); *Leverence v. USF&G*, 462 N.W. 2d 218 (Wis. App. 1990); *Flores v. Allstate Texas Lloyd's Co.*, 278 F.Supp.2d 810, 814 (S.D.Tex. 2003); *Salinas v. Allstate Texas Lloyd's Co.*, 278 F.Supp.2d 820, 822 (S.D. Tex. 2003); *Home Ins. Co. v. McClain*, 2000 WL 144115 (Tex. App.—Dallas 2000)(not designated for publication); *But see, Feiss v. State Farm Lloyds*, 2003 WL 21659408 (S.D. Tex. 2003) (unpublished); *Merrimack Mutual Fire Ins. Co. v. McCaffree*, 486 S.W.2d 616, 619-20 (Tex. Civ. App.—Dallas 1972, writ ref'd. n.r.e.).
- ⁴ *Ballard v. Fire Ins. Exchange*, Cause No. 99-05252, In the District Court of Travis County, Texas (June 1, 2001), withdrawn and revised, 2001 WL 883550 (Tex. Dist. August 01, 2001).
- ⁵ Mary Sit-DuVall, *Claims boost insurance rates, fraud*, Houston Chronicle, August 30, 2002
- ⁶ *Id.*
- ⁷ *Allison v. Fire Insurance Exchange*, 98 S.W.3d 227, 254 n.8 (Tex. App.—Austin 2002, pet. filed) [abated] (quoting from *Harsh Policies: Hit with Big Losses, Insurers Put Squeeze on Homeowners*, Wall Street Journal, May 14, 2002, at A1).
- ⁸ John W. Dreeste and Martha L. Perkins, *Mold Claims and Litigation: Information for Contract Sureties*; Surety Claims Institute Newsletter, February, 2003, at, 2-5.
- ⁹ Sit-DuVall, *Claims boost insurance rates, fraud, supra*.
- ¹⁰ See, e.g., Associated Press, *Insurance rate bill appears close to compromise*, Houston Chronicle, March 4, 2003; Janet Elliott, *Bill would lower insurance rates*, Houston Chronicle, January 30, 2003; Associated Press, *Homeowners testify about increasing insurance rates*, Houston Chronicle, February 20, 2003
- ¹¹ Dreeste and Perkins, *Mold Claims and Litigation: Information for Contract Sureties, supra*; Redd, *State of the Science on Molds and Human Health, supra*.
- ¹² Tex.Occ.Code Ann. §§1958.001-304.
- ¹³ *Allison, supra*; *Roche v. Lincoln Prop. Co.*, 2003 WL 22002716 (E.D. Va. 2003) (unpublished); *Dick v. Pacific Heights Townhouses*, 2002 Vol. 31117253 (Cal. App. 3d Dist. 2002) (unpublished); *But see, New Havenford Partnership v. Stroot*, 772 A.2d 192 (Del. 2001).
- ¹⁴ Patrick J. Wielinski, *Insurance Coverage for Mold Arising Out of Defective Workmanship*, IRMI.com, February, 2001: <http://www.irmi.com/expert/articles/wielinski004.asp>; Patrick J. Wielinski, *Policy Modifications and Endorsements Relating to Liability Insurance Coverage for Mold*, IRMI.com, March, 2002: <http://www.irmi.com/expert/articles/wielinski008.asp>; See, e.g., *Feiss, supra*; *Merrimack, supra*.
- ¹⁵ At least two other cases brought against sureties for remediation or property damage in California and Florida were settled prior to trial. In California, the parties, including the surety, settled by paying \$12,000,000.00, while in the Florida suit the performance bond sureties settled for \$35,000,000.00. See, *Santa Clara Gets \$12 Million Settlement in EIFS Case*, ENR (August 13, 2001); Ruggiero, Stephen S., *Anatomy of a Sick Building*, Progressive Architecture (August, 1994).
- ¹⁶ *Id.*
- ¹⁷ See, e.g., *Centex, supra*; *New Havenford Partnership, supra*.
- ¹⁸ The National Jury Verdict Review & Analysis, Vol. 17, No. 1 (March, 2003); *But see, Allison, supra* at 356-64 (overturning jury award of punitive damages).
- ¹⁹ Shannon Buggs, *Previous claims can lead to blackballing of homes*, Houston Chronicle, December 9, 2002
- ²⁰ *Allison, supra* at 259.
- ²¹ *Centex, supra*.
- ²² *Id.*; For a discussion of the difference between the *Frye* test used in Florida state courts and the test for admissibility of expert testimony in federal courts and most other states, See, *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993).
- ²³ *Allison, supra* at 239-240; see also, *Roche, supra* at *4-5; *Dick, supra* at *3-6; *But see, New Havenford Partnership, 772 A.2d at 798-800.*
- ²⁴ *Redd, supra* at p.p. 3-4 and 10.
- ²⁵ See generally, *General Conditions of the Contract for Construction*, AIA Document A201-1997 (1997 edition).
- ²⁶ *Id.* at sections 4.3, 5.4, 6.1, 10.3, 10.5, 11.3, and 11.4.
- ²⁷ *Id.* at sections 3.18, 4.3, 5.3, 8.2, 9.10, 10.2, 10.4, 11.1, 11.3, 11.4, 11.5, and 12.

²⁸ *Id.* at sections 4.3.10, 9.10.5, 11.4.3, 11.4.5, and 11.4.7.

²⁹ See, e.g., *Touchet Valey Grain Growers, Inc. v. Opp & Seibold General Construction Co., Inc.*, 831 P.2d 724 (Wash. 1992); *Village of Rosemont v. Leatin Lumber Co.*, 494 N.E. 2d 592 (Ill. App. 1986).

³⁰ Wielinski, *Insurance Coverage for Mold Arising Out of Defective Workmanship*, *supra* note 14; Wielinski, *Policy Modifications and Endorsements Relating to Liability Insurance Coverage for Mold*, *supra*.

³¹ *Id.*

³² *Donald*, *supra*; *Leverence*, *supra*. However, some homeowners policies have been interpreted as excluding coverage for mold for decades. See, e.g., *Merrimack*, *supra*.

³³ *Id.*

³⁴ Wielinski, *Insurance Coverage for Mold Arising Out of Defective Workmanship*, *supra*; Wielinski, *Policy Modifications and Endorsements Relating to Liability Insurance Coverage for Mold*, *supra*; Wielinski, *More on Defective Work as an Occurrence*, *supra*.

³⁵ Wielinski, *Policy Modifications and Endorsements Relating to Liability Insurance Coverage for Mold*, *supra* note 14.

³⁶ *Id.*

³⁷ See, e.g., *Hardware Dealers Mutual Ins. Co. v. R.H. Hidey, Inc.*, 84 N.W.2d 795 (Mich. 1957)

³⁸ *Id.*

³⁹ *Centex*, *supra*.

⁴⁰ *Id.*

⁴¹ In the context of a homeowner's claim against the contractors, a Texas court held the discovery rule delayed the running of the limitation period until the date the owners became aware of the water leaks that caused the mold growth. The court also found that the contractor's knowledge of, and its failure to disclose, the continued presence of the leaks after repairs had been made suspended the running of the limitations period under the doctrine of "fraudulent concealment". *Booker v. Real Homes, Inc.*, 103 S.W.3d 487 (Tex. App.—San Antonio 2003, pet. denied).

⁴² *Centex*, *supra*.

⁴³ Florida Solar Energy Center, *Managing Mold in Your Florida Home: A Consumer Guide*; Dreste and Perkins, *Mold Claims and Litigation: Information for Contract Sureties*, *supra*.

⁴⁴ *L&A Contracting Co. v. Southern Concrete Services, Inc.*, 17 F.3d 106, 109 (5th Cir. 1994).

⁴⁵ *Id.* at 110–11.

⁴⁶ *Id.* at 111 n.15.

⁴⁷ Florida Solar Energy Center, *Managing Mold in Your Florida Home: A Consumer Guide*, *supra* note ____; *A Buyer's Guide to Handling Mold Claims and Litigation*, *supra* note ____.

⁴⁸ Associated Press, *Insurance rate bill appears close to compromise*, *supra*.

⁴⁹ Florida Solar Energy Center, *Managing Mold in Your Florida Home: A Consumer Guide*, *supra*; Dreste and Perkins, *Mold Claims and Litigation: Information for Contract Sureties*, *supra*.

⁵⁰ See, *Trevino v. Ortega*, 969 S.W.2d 950 (Tex. 1998), for a general discussion of "spoliation" and the different remedial measures taken by state and federal courts across the country.

⁵¹ Dreste and Perkins, *Mold Claims and Litigation: Information for Contract Sureties*, *supra*.

⁵² **In the attached Appendix we have provided sample language that is being used by insurers to limit their exposure to mold claims, and drafts of letters, contract terms, and bond terms that could be used by the surety to address the issue. These samples are provided for illustration purposes only and are not intended to constitute legal advice from the authors or their firm. We can not state that these samples, if used, would be sufficient to achieve the desired outcomes for the surety referenced in this paper. A surety facing a mold claim is strongly urged to seek independent legal advice. This paper is not intended to be a substitute for such advice.**

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APPENDIX 1

Sample language for Pathogenic Organisms Exclusions used by property insurers

Sample 1: This insurance does not apply to:

1. “Bodily Injury” [or] “Property Damage” . . . arising out of any “pathogenic organisms”, regardless of any other cause or event that contributed concurrently or in any sequence to that injury or damage.

‘Pathogen [sic] organisms’ means any bacteria yeasts, mildew, virus, fungi, mold or their spores, mycotoxins or other metabolic products.

Sample 2: The following exclusion is added to Section 2. Exclusions in Section 1.A.
BODILY DAMAGE AND PROPERTY DAMAGE LIABILITY.

- A. This insurance does not apply to “bodily injury” or “property damage” that is within the definition of the “products-completed operations hazard” and that either consists of, is caused by, arises out of, or is aggravated by “moisture related deterioration.” This exclusion applies even if causes other than “moisture related deterioration” add to or contribute, directly, indirectly, or in any manner or sequence to the “bodily injury” or “property damage.”
- B. This exclusion does not apply if the “bodily injury” or “property damage” consists of, is caused by, or arises out of any of the following:
 1. The “collapse” of any building or structure.
 2. Water escaping from within leaking or bursting pipes, plumbing fixtures, appliances, or equipment located within a building or structure.
 3. The presence or entry of liquid or frozen water into the occupied spaces of a building.
- C. “Moisture related deterioration” means:
 1. Mold, mildew, fungi, or their spores, scent or byproducts.
 2. Rot, decay, corrosion, or other gradual deterioration, delamination, adhesive or cohesive failure, weakening, or deformation of wood products or other material caused by continuous and/or prolonged and/or repeated contact with water or moisture. This definition applies even if the water and/or moisture also contain chemical elements other than water.
- D. “Collapse” means the abrupt falling-in, abrupt loss of shape, or abrupt flattening into a mass of rubble of a building or structure.

APPENDIX 2

Sample Definition of Mold used by insurers to include mold under pollution legal liability and contractors pollution liability riders or policies

Pollution Conditions means the discharge, dispersal, release or escape of any solid, liquid, gaseous or thermal irritant or contaminant, including smoke, vapors, soot, fumes, acids, alkalis, toxic chemicals, medical waste, and waste materials into or upon land, or any structure on land, the atmosphere or any watercourse or body of water, including groundwater, provided such conditions are not naturally present in the environment in the amounts and concentrations discovered. Pollution Conditions shall include Mircobial Matters in any structure on land and the atmosphere contained within that structure.

Microbial Matters means fungi or bacterial matter which reproduces through the release of spores or the splitting of cells, including but not limited to, mold, mildew and viruses, whether or not Microbial Matter is living.

APPENDIX 3
Sample Definition of Policy Rider providing Limited Mold Coverage

LIMITED FUNGI OR BACTERIA COVERAGE

This endorsement modifies insurance provided under the following:

COMMERCIAL GENERAL LIABILITY COVERAGE PART

Schedule

Fungi and Bacterial Liability Aggregate Limit \$_____

A. The following exclusion is added to Paragraph 2., Exclusions of **Section I – Coverage B – Personal and Advertising Injury Liability**:

2. **Exclusions**

This insurance does not apply to:

- a. “Personal and advertising injury” arising out of a “fungi or bacteria incident.”
 - b. Any loss, cost or expense arising out of the abating, testing for, monitoring, cleaning up, removing, containing, treating, detoxifying, neutralizing, remediating or disposing of, or in any way responding to, or assessing the effects of “fungi” or bacteria, by any insured or by any other person or entity.
- B. Coverage provided by this insurance for “bodily injury” or “property damage” arising out of a “fungi or bacteria incident”, is subject to the Fungi and Bacteria Liability Aggregate Limit as described in Paragraph C of this endorsement. This provision B does not apply to any “fungi” or bacteria that are, are on, or are contained in, a good or product intended for consumption.
- C. The following are added to **Section III – Limits of Insurance**:
1. Subject to paragraphs 2. and 3. of **Section III – Limits of Insurance**, as applicable, the Fungi and Bacteria Liability Aggregate Limit shown in the Schedule of this endorsement is the most we will pay under Coverage A for all “bodily injury” or “property damage” and Coverage C. for Medical Payments arising out of one or more “fungi or bacteria incidents.” This provision does not apply to any “fungi” or bacteria that are, are on, or are contained in, a good or product intended for consumption.

D. The following definitions are added to the Definitions Section:

1. "Fungi" means any type or form of fungus, including mold or mildew and any mycotoxins, spores, scents, or byproducts produced or released by fungi.
2. "Fungi or bacterial incident" means an incident which would not have occurred in whole or in part, but for the actual, alleged or threatened inhalation of, ingestion of, contact with, exposure to, existence of, or presence of, any "fungi" or bacteria on or within a building or structure, including its contents, regardless of whether any other cause, event, material or product contributed concurrently or in any sequence to such injury or damage.

APPENDIX 4
Sample Mold Disclosure and Disclaimer Addendum for
inclusion into the General Contract with the Owner

I. DISCLOSURE:

Mold and other environmental contaminants are present in our environment. Some types of mold may be hazardous to the health of humans. The various factors causing mold growth and as the interaction of many building and environmental factors are beyond contractor's control in many instances. As a result, Contractor cannot warrant, represent or guarantee that mold will not grow in your building or structure.

Mold can be caused by the presence of excessive moisture or the accumulation of water indoors. You should regularly monitor and inspect your building or structure for mold growth or the presence of moisture problems. Should any moisture-related problems be discovered, they should be repaired immediately by a qualified contractor. The following are suggestions that may assist you in preventing and addressing mold growth in your building or structure:

- Respond promptly when you see signs of moisture or mold.
- Report the existence of mold and the possibility of a related claim to your insurer(s).
- do not allow moisture to stand or make contact with cellulose-based materials, such as wood, drywall or other non-tile, non-plastic or non-metal materials.
- Fix leaking plumbing and any other source of unwanted water immediately.
- Report all leaks immediately to _____ so that they may be fixed.
- Maintain proper indoor humidity and temperature.
- Keep water away from the foundation by maintaining required slopes, drainage and landscaping.
- Dry all water damaged areas and items immediately to prevent the growth of mold.
- if mold develops, depending upon the nature and extent of mold infestation, trained professionals may be needed to assist in the remediation effort.
- Mold that is not adequately and properly removed may reappear.
- Absorbent materials (such as ceiling tiles, carpet and most furniture) that become moldy should be replaced, along with any materials that has moldy residue, such as rags, paper, leaves or debris.

APPENDIX 5
Sample Reservation of Rights Letter from Surety to Owner

Dear _____[owner]:

We are in receipt of your notice letter of _____, in which you notified us of your declaration of an alleged default and termination of our principal under the terms of the general contract of _____, and you demanded that we perform the principal's remaining obligations, if any, pursuant to the terms of the performance bond we issued.

Based on the demand in your letter, we are initiating an investigation into your claim under the bond. While we are investigating this claim, please understand that we do not accept or exercise any control over, or possession of, the project site and/or comprised portions of the project. Accordingly, you should take the following certain steps to protect us, the project, and the principal from any damages that could be mitigated by immediate action. These steps should include protection of the site, and the work product and materials, from water penetration. Also, please provide us with a copy of all of the certificates of insurance issued for this project. Finally, please provide us with copies of all documents evidencing payments made to, or on behalf of the principal, and the balance of the retainage currently withheld.

We are taking this action for our sole benefit, and for the protection of our rights under the performance bond and the applicable law, while reserving all of our rights and defenses to coverage. This reservation of rights includes, but is not limited to, our right to limit any and all obligations under the bond to its penal sum, and all rights of subrogation under the contract, under law, and at equity. It is not the intention of the Surety in initiating the steps outlined above to waive, prejudice, amend, alter, revise, release, or in any way adversely affect any of the following:

1. the terms of the Contract between the Principal and the Obligee;
2. the terms of the performance bond;
3. the coverage of any applicable insurance policy; and
4. any claim, cause of action or defense known or unknown that the Surety may have against either the Principal or the Obligee; or rights Principal or Obligee may have against such others.

Please acknowledge these reservations of rights by signing and returning this letter as provided below.

APPENDIX 6
Sample Clause for inclusion in Performance Bond
to exclude coverage for Mold Claims

Notwithstanding any other provision of this bond, the contract, or any policy of insurance required to be, or actually obtained by the obligee or principal, the obligation of the surety under this bond shall not extend to claims of breach of contract, breach of warranty, or any other claims, asserted under any theory of recovery, for property damage, or personal injury arising from or related to, in whole or in part, the discharge, dispersal, release, escape, or growth of any bacteria, yeasts, mildew, virus, fungi, mold, or their respective mycotoxins or other metabolic organisms.

APPENDIX 7
Sample Clause for inclusion in General
Indemnity Agreement to allow intervention by Surety

In the event the Principal, Indemnitor or Surety becomes aware of the existence or development of a condition of, or at the site of, the Project that could lead to a claim or loss under the bond, the Surety may, in its sole discretion but without obligation, inspect the Project site, review and inspect any other items the Surety deems required for inspection, and recommend preventive, remediation, corrective or such other action as the Surety may consider warranted to respond to any such condition. Any such action taken by the Surety will not lead to liability to the Principal or Indemnitor. The Principal shall implement such recommendations at its own cost and expense, failing which Surety may employ others to have such recommendations implemented and obtain reimbursement therefore from Principal and/or Indemnitor(s).

APPENDIX 8

Managing the Risk of Mold In the Construction of New Buildings

*Draft Guidance For Building Owners, Construction Contractors and Other Parties to the
Construction Process (January 2003)*

SEE ATTACHED DOCUMENT