All Washed Up

Fighting Water Restoration Contractor Fraud

By Gene A. Weisberg and Dave Petrelli

First party property insurance fraud investigation and analysis generally focuses on whether the policyholder has falsified a claim. But when real water damage occurs, a fraudulent claim often involves both the policyholder and the insurer being defrauded, with the water restoration contractor, not the insured, committing the fraud. Contractors license laws, as well as unfair business practices laws, may provide the ammunition needed to prevent water restoration contractors from taking advantage of both the policyholder and the insurer.

Contractors license laws have evolved over the years in a number of states as a result of predatory practices by which building contractors persuaded homeowners to enter into contracts for repair or remodeling and then charged exorbitant and undisclosed prices. If the building owner objects or refuses to pay once the charges are revealed, the contractor files a mechanics lien and threatens to sell the building to pay the amount claimed. Among the limitations the law imposes to prevent these practices is to require all contract terms to be in writing, including what price will be charged for the work, and disclosed before the work is performed. The customer also must be given written notice of a cooling off period, typically three days (although longer during a declared emergency), during which the contract can be canceled without any legal liability.

In a typical construction situation, this works well because construction will normally not be started in less than three days and an estimate of the cost of the planned work can be provided. But when an emergency situation arises, such as a water pipe break or sewage backup, repairs are needed immediately. This situation creates an opportunity for a contractor to claim he or she cannot determine the cost of the work until the work is well underway, and there can be no three-day cooling off period. These are situations prone to fraud, on both the insured and insurer.

State Laws

California law requires that contractors include information regarding the estimated cost of work to be performed in their contracts. This information must be provided, and the customer must be given a fully executed copy of the agreement, before work begins. When the required disclosures are not given, the construction contract is not valid or enforceable. Although, in an emergency situation the three-day cooling off period may be waived, these other requirements may not. This is especially true with regard to damage and repairs to residential property, whether single family homes or apartments. Both the building owners and tenants may be contracting parties.

The general rule is that "a contract made in violation of a regulatory statute is void," (*Hinerfeld-Ward, Inc. v. Lipian*). Courts should not "lend their aid to the enforcement of an illegal agreement or one against public policy …" Although

courts have held that a contract that violates the legal requirements is not necessarily void where the parties are sophisticated, or other special circumstances exist, the contract still may be voidable at the consumer's election. If the consumer is one that the statute was designed to protect, however, the contract likely will be void.

California Business & Professions Code § 7151.2 provides in pertinent part as follows:

"'Home improvement contract' means an agreement, whether oral or written, or contained in one or more documents, between a contractor and an owner or between a contractor and a tenant, regardless of the number of residence or dwelling units contained in the building in which the tenant resides, if the work is to be performed in, to, or upon the residence or dwelling unit of the tenant, for the performance

of a home improvement as defined in Section 7151, and includes all labor, services, and materials to be furnished and performed thereunder. ..."

Other statutes define some of the terms used in this definition, such as defining "home improvement" to include repairing residential properties and "services" to includes work and labor furnished in connection with residential premises repairs.

Clean Up

In a typical scenario, a home or apartment owner suffers a water pipe break or sewage backup and calls a plumber. The plumber will stop the leak, but then recommend that a water restoration contractor be called to clean up. That contractor will be contacted because the resident or apartment owner has a wet and smelly mess that needs immediate attention. If the building is not dried, mold may start to grow and exacerbate the situation. Thus, the contractor, appropriately, will let the owner or resident know that work must take place immediately.

Where the fair and honest situation breaks down is when the contractor says he cannot predict what the work will cost until he tears out walls and determines the extent of the damage. It may be true that the full cost will not be known. The law accounts for this by providing a mechanism for change orders. If the initial contract amount turns out not to be sufficient, the contractor can go to the customer with a proposal for additional work, again disclosing the agreed price before that additional work is done. This gives the customer a chance to stop the work, or consult with another contractor.

When there is no agreed price before the work is started, contractors build up costs by, for example, bringing all the fans and other drying equipment to the building that can fit in their trucks and charging for renting all of them, even if not all are used. In fact, often there would not be room to use all of them and they sit in a garage unused, but accumulating daily rental charges.

Another tactic is to start removing walls, floors, and cabinets well beyond what is wet. This not only increases the demolition and disposal costs, but also increases the cost of needed repairs to restore the structure. For example, why would ceramic shower tile need to be removed because it gets wet in a water damage event? Although there may be circumstances when it is necessary, like when materials behind the tile gets wet from above or below and cannot be dried without removal, this is something that should be evaluated before assuming that demolition is necessary.

Contractor Games

Some contractors create separate companies, only one of which is licensed. They use the unlicensed company to remove walls, floors, cabinets, and other surfaces, and rent drying equipment. They claim no license is needed because they are not building or repairing anything and, therefore, the cost disclosure and cancellation notice requirements do not apply. They have their licensed company then contract to put the building back together. This is a very narrow reading of what "repair" means. The California Contractors State License Board recently suspended a licensed sister company, and prosecuted the unlicensed company and owner, for this tactic.

Contractors often will tell the customer to sign the contract because they will accept what the insurance company pays. If, however, the insurer refuses to pay unreasonable amounts, the contractor can file a mechanics lien and threaten to foreclose on it, putting the insurer in an adverse situation with the insured. Some insurers will step into the insured's shoes and defend against these claims, even without a contractual defense obligation, because it may be seen as the insurer's money that is being protected.

This is a good opportunity for the insurer and policyholder to partner to battle fraud. Although those who investigate and litigate insurance fraud see many dishonest policyholders, the vast majority of insureds object to fraud, whether a policyholder or contractor commits it. Thus, many insureds will cooperate, as long as their interests are protected. Stepping in to stop enforcement of mechanics liens can take the pressure off of the insured and remove the contractor's ability to apply that pressure, giving time to battle the issues relating to improper scope of work and billing practices.

Unfair business practices laws, such as California Business & Professions Code § 17200, also can be used to both obtain injunctions to stop this type of tactic, and to disgorge amounts improperly charged and collected.

Although insureds can hire whomever they want to fix their damage, water damages create an opportunity for an insurer and its consultants to educate the policyholder as to what work is required, and what cost is appropriate. The result not only can save both the insurer and the policyholder money, but also lead to better quality and more appropriate work. Failing to fight this type of fraud encourages water restoration contractors to continue this type of improper practice, at great cost to insurance companies. In this setting, finding and fighting fraud can create an alliance between the insured and the insurer and benefit both.

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