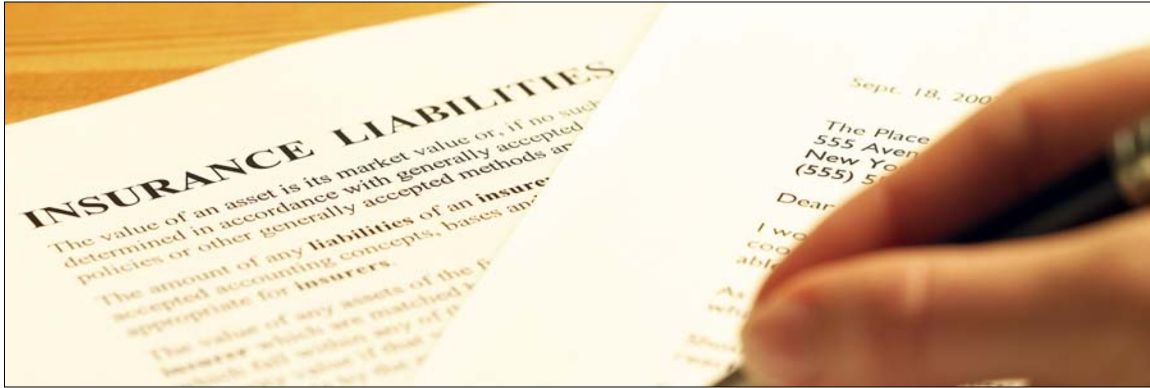
Chapter 01

Reducing Costs for Commercial General Liability Insurance



One of the major member benefit services of the Western States Contractors' Alliance is providing educational programs designed to address major issues facing the building industry. These course materials have two parts: (a) an educational section written in non-technical language and (b) a brief test at the end of each chapter on the materials contained therein.

By studying the course materials and successfully passing the tests, contractors can benefit in two major ways:

1. Qualify for reductions in premiums for commercial general liability insurance (CGL)

2. Avoid time consuming litigation that diverts management and employee attention from the primary purposes of the business

The educational material contained in this course addresses one of the major problems facing the building industry: the rising costs of CGL caused by a striking increase in construction defect litigation (CDL). That increase has reached crisis levels that seriously affect not only the cost of CGL, but even the availability of insurance coverage itself.

This chapter covers the following major subjects:

1.01 Significance of the CGL cost problem
1.02 Types of construction defects
1.03 Overview of course material
1.04 Brief summary of each major section
1.05 Other steps not included in this course
1.06 Conclusion

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1.01 Significance of the CGL Cost Problem

CGL insurance coverage is currently in a crisis mode for construction in many areas of the country due to a number of issues, foremost among them being CDL. Contractors are seeing significant premium increases for CGL coverage ranging from as high as 600 percent to 1,000 percent on a year-over-year basis in some states, such as California and Nevada. The cost of this insurance is the second highest insurance cost behind only workers' compensation coverage. Moreover, significant policy exclusions are prevalent, including exclusions for project types covering the range from single family residences, especially in large master planned developments, to multi-family units in apartments and condominiums.

The increase in CDL has spread throughout the building industry, with the residential segment particularly hit hard:

- Although CDL originally started in the condominium market, it has spread to all forms of multi-family housing and to large tracts of single-family homes. Today, even small builders of single-family homes are not immune to the impact of CDL issues.

- CDL makes building and insurance more expensive; therefore, fewer residences are built and those that are built are more costly. Lawyers who file CDL cases say the defects are real and point to J.D. Powers' 2003 New Home Builder Study of 21 metropolitan markets, which says there is an average of 1,372 construction problems per 100 homes, which translates to 13.72 per home. In Atlanta, where construction problems were the highest in the nation, buyers experienced 1,439 problems per 100 homes, 14.39 per home.

- CDL makes insurance difficult or impossible for interested builders to obtain, particularly for condominium construction, substantially reducing the construction of this form of multi-family ownership housing.

Condominium CDL in particular has spread like wildfire up the West Coast and into other states, where there is a demand for multi-family housing, such as Arizona, Colorado, Nevada, and Florida. In most cases, condominium associations are prompted to sue their contractors after receiving letters warning of personal liability from law firms specializing in construction defect cases. The letters point out that condominium officers have a fiduciary duty to find and correct potential construction defects. When faced with the threat of personal liability for failure to bring action, association members often agree to rip apart finished units in the hunt for defects. Sometimes the contractor is sued before defects are even discovered. Condominium construction defect cases prove profitable for the attorneys involved because builders and insurance companies are often forced to settle out of court in a desperate effort to save legal expenses.

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1.02 Types of Construction Defects

Almost any condition that reduces the value of a home, condominium, or common area can be legally recognized as a defect in design or workmanship or a defect related to landslide settlement conditions. Courts throughout the United States have recognized that construction defects are tangible and can typically be grouped into the following major categories:

- **Design Deficiencies:** Sometimes, design professionals, such as architects or engineers, design buildings and systems, which from a performance standpoint, do not always work as intended or as specified. For example, problems are typically encountered with roof systems, due to their design complexity, pitched or flat, are prone to leaks. A majority of roofing problems are the direct results of the improper specification of building materials, which can result in water penetration, intrusion, or other problems, as well as poor drainage design and/or the inadequacy of structural members, which can result in cracks or deterioration of roofing components and materials.

- **Material Deficiencies:** Common manufacturer problems with building materials can include deteriorating flashing, building paper, waterproofing membranes, asphalt roofing shingles, particle board, inferior drywall, and other wall products used in wet and/or damp areas, such as bathrooms and laundry rooms. One example of using inferior building materials is windows that leak, even though properly installed.

- **Construction Deficiencies:** Poor quality workmanship often manifests itself as water infiltration through some portion of the building structure. The list of problems includes cracks in foundations, floor slabs, walls, dry rotting of wood or other building materials, termite or other pest infestations, electrical and mechanical problems, plumbing leaks and back-ups, lack of appropriate sound insulation, and/or fire-resistive construction between adjacent housing units, etc. Again, leaking windows serve as an illustrative example since they are a common defect and prevention requires good workmanship. Window leaks can result from many things including rough framing not being flush with the outside at openings, improper flashing, improperly applied building paper, window frames racked during storage/moving, lack of sheet metal drip edge above window header, and so on.

- **Subsurface/Geotechnical Problems:** California, Colorado, and other parts of the country have a significant amount of expansive soil conditions. As a result of this type of terrain, there have been many problems with housing subdivisions and/or developments built into the hills or other sloping areas where it is difficult to provide a solid and/or stable foundation. If the subsurface conditions in these subdivisions and/or developments are not properly compacted and prepared for adequate drainage, problems will inevitably result, which can include vertical and horizontal

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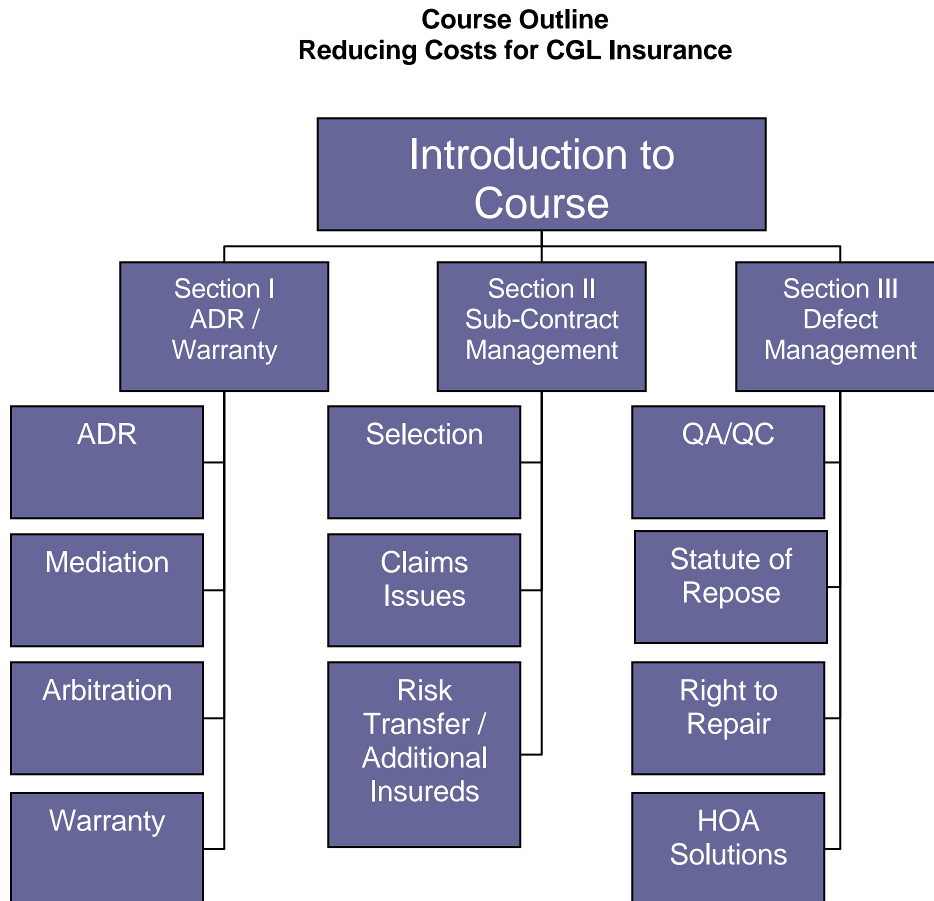
settlement (subsidence), movement (expansion), slope failures, flooding, and in extremely wet/rainy climates landslides, etc. could occur. These types of conditions typically lead to cracked foundations, floor slabs, and other damage to the building. A worst-case scenario in some instances could render a building uninhabitable and/or uninsurable.

In some instances, of course, owner and consumer problems are the result of a combination of several of the above defects. For example, mold resulting from water intrusion may be the result of design, material, or construction deficiencies.

1.03 Overview of Course Material

The problem of minimizing CDL is a complex one since there are so many alternative actions available, each with its own set of complexities. To facilitate contractor understanding and ability to select the appropriate alternative and to avoid litigation, the steps that can be taken – and hence the material in this course – are divided into three major categories. These are shown in the diagram below.

Course Outline
Reducing Costs for CGL Insurance



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1.04 Brief Summary of Each Major Section

The following is brief summary of the three major sections in this course, which includes the key components of each section.

Section I – Alternative Dispute Resolution (ADR)/Warranty

The term Alternative Dispute Resolution (ADR) covers a variety of techniques. Typically, the parties to a dispute agree in advance or after a dispute arises to resolve the dispute by resort to a means other than traditional litigation in a court of law. Thus ADR is a means of avoiding a legal trial, without all the time, expense, formalities, and the like that are typically involved therein. The two most important of these ADR techniques are:

- **Mediation:** Mediation is a voluntary method of dispute resolution that allows parties to craft their own solution to a dispute. An unbiased third party (the mediator) assists the parties in this process by conducting private interviews and negotiations with each party to discuss settlement opportunities and facilitate an agreeable solution. Mediators never impose decisions on disputing parties; rather, they encourage disputing parties to find common ground and resolve their dispute on their own terms.

- **Arbitration:** Arbitration is a method whereby disputes are brought before a neutral third party (the arbitrator) who, after carefully reviewing all of the relevant information, issues a final decision in favor of one of the parties. Consumers, businesses, and government departments — even courts themselves — have successfully used arbitration programs to resolve disputes, and there is widespread satisfaction with the process. Arbitration offers parties a decisive legal outcome to their dispute without the expense and inconvenience of court proceedings and attorney fees.

In addition, the chapter also discusses some other forms of ADR that have proven effective in some cases in replacing litigation.

The chapter closes with a discussion of warranties. Warranties have become an increasingly important tool in the continuum of steps available to builder and remodelors to avoid CDL. To provide adequate safeguards, builders should provide an express, limited written warranty that recognizes and addresses any statutory and/or implied provisions of the state in which it is written.

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Section II – Sub-Contract Management

Like many other facets of the building industry, the subject of sub-contractor management has also become increasingly complex. This is driven by such factors as government regulations that increase the responsibilities of general contractors and insurance company programs that shift part of the increasingly expensive risk to sub-contractors.

Obviously, all contractors want to hire "good subs" who come in on time, do their work efficiently, and complete their assignment at the price, quality, and schedule quoted. If that was always the case, this section of the course would not be necessary.

However, the reality is that not only is this not always the case even with "good subs," but also there are substantial opportunities for builders to decrease their costs and risks by improving the managing of their sub-contractors.

To this end, Section II covers:

- **Selection:** By careful selection of sub-contractors including examination of some factors not usually included in the selection process, builders can minimize their risks and hence lower their costs. This portion of the course includes a sub-contractor selection scorecard for evaluating each potential sub-contractor on the basis of important selection criteria.

- **Claims Management:** Unfortunately, injuries do occur and performance claims arise. Clearly, consistent reporting procedures can help to minimize costs and to support the contractor's legal defense. Separate attention is paid to two additional subjects: the difference between warranty and construction defect claims and the difference between premises open claims and workmen's comp related claims. An understanding of these differences is an important factor in the management of claims on the job.

- **Risk Transfer/Additional Insured:** To protect themselves and minimize risk, contractors seek to transfer that risk, or a portion thereof, to the sub-contractors whom they hire. They do so through the contract between the two parties in which the contractor seeks indemnification from acts by the sub-contractor and additional protection as an additional insured (AI) on the sub-contractor's policy.

  As the International Risk Management Institute (IRMI) notes in the Preface to its course on the subject of Additional Insured Status, "The topic of additional insured status is a difficult one at best. Many misconceptions result when adding contracting parties to one another's insurance policies as additional insureds."

  This chapter includes resource information on obtaining basic contracts for sub-contractors. Material is included to alert contractors to some of the basic areas for concern in their contract agreements and actions whereby contractors can protect themselves. In addition, it also discusses how contractors can achieve risk transfer goals independent of insurance endorsements.

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Section III - Defect Management

The third major area for reducing contractor exposure to CDL falls under the general heading of defect management. This subject has three basic components:

- **Reducing/eliminating defects during the building process:** During the past decade, the building industry has witnessed substantial changes in quality control/quality assurance (QC/QA) programs to minimize construction errors from the design phase all the way through to completion. Increasingly emphasis is being placed on programs that view home construction as a system, including reviews of plans and specifications, education of construction employees, field inspection of all critical construction steps, collection and analysis of data, problem identification, and correction and compilation of a final reports on all of the QC/QA steps taken in case needed at a later time.

  This chapter also deals with national organizations such as the National Association of Home Builders (NAHB) on efforts to improve QC/QA through their industry through such steps as the creation of the National Housing Quality Program as the focal point for the advancement of quality control practices in residential construction.

- **Educating homeowners:** Homeowner education has three basic phases. The first deals with educating potential homeowners on the basic standards for construction so that they know what to expect. Some contractors now incorporate written allowable construction standard guidelines into their contracts. The second is informing consumers of the drawbacks and consequences of filing lawsuits before exhausting all other avenues. And the third deals with advising homeowners of their responsibilities for normal maintenance and minor repairs. Some builders include separate maintenance publications as part of their warranty programs and require buyers to sign receipts acknowledging their review and possession of the information.

- **Understanding the process:** The third major area of defect management is understanding the process so that contractors are better equipped to minimize their risks if a customer complaint seems headed for litigation. Three important statutes are part of this process. As discussed more fully in the appropriate section of this course material, they are:

  - **Statute of Repose:** This statute covers claims arising out of any of a long list of construction-related improvements to real property. Any claims arising out of this list of specified activities must "accrue" within a period of time – known as the statute of repose. Accrual of a cause of action occurs when the plaintiff has the legal right and sufficient facts to bring suit.

  - **Statute of Limitations:** If a cause of action accrues within the period specified in the statute of repose, then the time period specified in the applicable statute of limitations begins to run from the point of accrual (which can occur at any point during the period covered by the Statute of Repose).

  - **Right of Repair:** The Right of Repair (RoR) allows the contractor, or sub-contractor, a period of time to correct any deficiencies in workmanship and materials before the owners can bring suit for these alleged defects.

Finally, this section concludes with a discussion on some of the steps that contractors and developers can take in forming homeowner associations (HOA) in condominiums, multi-family apartments, and even large developments to protect themselves against later claims by the residents.

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1.05 Other Steps Not Included In This Course

There are several additional courses of action, which contractors can take to reduce and/or prevent CDL. While these steps are not covered in the same detail as other alternatives in this educational program, they are discussed briefly below because of their obvious relevancy to this subject. They are:

- **Changing State Laws:** In today's market, defects in housing construction are subject to lawsuits on a strict liability basis. Strict liability is the lowest standard for fault. It means that someone suing over damage caused by a construction defect does not need to prove that the builders was negligent (did not act as a reasonable prudent builder should have acted), but only that the house or multi- family structure was defective as built.

  The typical construction defect case consists of a direct action filed by a HOA board or an individual owner within a particular subdivision or development against the builder or developer of the home. The complaint typically asserts causes of action for negligence, breach of contract, breach of warranty, and statutory damages against the builder or contractor. The developer or builder files third-party action against the various designers, subcontractors, and material suppliers that provided construction services and supplies to the involved development.

  In response, a number of states have enacted Notice and Opportunity to Repair legislation. These laws give construction professionals the opportunity to be informed of defects and make repairs before a suit can be filed. Many states, which passed these laws, have used model bill language endorsed by the American Legislative Exchange Council (ALEC). To date, 19 states have Notice and Opportunity to Repair or related laws on record.

  Most states impose time limits on construction defect claims by Statutes of Repose and Statutes of Limitations. Statutes of Repose specify the time period with which a cause of action can arise at all. Under these statutes, the limitation period may expire before the plaintiffs' cause of action has arisen. Conversely, Statutes of Limitations foreclose suits after a fixed period of time following occurrence or discovery of an injury. In most states, the time limits begin to run when the defect is discovered, or should have been discovered by a reasonable person. If the defect is patent, or apparent based on reasonable inspection, the action against the defendant must begin within the time period specified by law. If the defect is latent, or nor readily apparent by reasonable inspection, any action to recover damages generally must be within ten years after improvements are substantially completed.

- **Forming Separate Companies:** To protect themselves, some contractors and developers are forming limited liability companies with the life of a single project. Thus, every project has its own unique contracting entity formed solely for the project.

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- **Using Owner-Controlled Insurance Programs:** Given that subcontractors in certain specialty areas cannot obtain insurance at any cost, some developers are migrating towards owner-controlled insurance programs (OCIP) to handle insurance requirements. The goal of OCIP is to lower the overall insurance cost of a project. Instead of every contractor purchasing separate liability, equipment, worker's compensation, and other project policies, one master or "wrap-up" policy is used. The "wrap-up" policy would be purchased to cover all construction activities during the project or subsequent to construction in the case of CGL coverage issues. On a large project, the economies of scale in purchasing a significant amount of insurance become substantial. Therefore, large owners and large managing/prime contractors are able to effect significant savings. They have been implemented on a variety of construction projects in both the single and multi-family markets.

  The risk of having sub-trades going bare without insurance is equally unpalatable. The solution to this insurance problem is a unified CGL OCIP policy that covers the entire project.

  Despite the advantages of an OCIP, there is one major disadvantage. If the insurance carrier for the OCIP goes out of business and is not an admitted carrier in that state, the entire project is without insurance coverage. Without viable insurance coverage in place, aggressive lawyers for plaintiffs may decide to seek compensation out of the business and personal assets of the contractors.

1.06 Conclusion/Summary

The very real crisis in obtaining commercial general liability insurance at any reasonable costs – and sometimes at any cost – has developed because of the increasing prevalence of CDL. The educational material in this manual provides a real basis for action by contractors to reduce those costs through better knowledge and application of a variety of techniques available to them. The material covers three major sections: Alternative Dispute Resolution/Warranties, Sub-Contractor Management, and Defect Management.

This educational program is one of the benefits available only to members of the Western State Contractors' Alliance. Any questions, comments, or additional assistance can be obtained by contacting the Western States Contractors' Alliance:

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