



THE LIABILITY INSURANCE CRISIS FOR BUILDERS: REASONS AND RESPONSES

INTRODUCTION Liability insurance is the single most important component of a builder's insurance program. It provides coverage for the insured builder for damages resulting from certain claims asserted by third parties. This coverage includes claims for bodily injury, property damage, advertising injury and personal injury, all as defined by the policy.

The general liability policy is intended to cover a wide range of third party claims involving both "premises-operations" exposures (e.g., a slip and fall at the builder's offices; a job site injury to a worker), as well as "products-completed operations" exposures (construction defect claims are a notable example).

Today, builders are confronting a liability insurance crisis. Due to adverse insurance market conditions, liability coverage for builders is less available, more expensive and more restrictive in terms of the coverage afforded. Builders always have been a difficult class of business to insure. The proliferation of construction defect lawsuits has resulted in enormous losses for liability insurers. The insurance crisis is most acute in states with the highest incidence of construction defect litigation, but the liability insurance crisis has spread nationwide.

However, builders have a number of responses available to assist in surviving the current crisis. In particular, builders should approach risk management as more than simply buying insurance. Non-insurance risk management strategies - designed to avoid, minimize and/or shift liabilities - must become a core part of every builder's company philosophy and operational practices. Effective implementation of such strategies increasingly will be a prerequisite for builders to qualify for adequate liability insurance, both in the current market and in the future.

GENERAL LIABILITY INSURANCE: SOME BASICS Most builders maintain a conventional liability insurance program, which is renewed annually and typically contains a primary liability insurance policy and an umbrella or excess policy, with limits of liability selected by the builder with input from its insurance broker. In the event of a third party claim or suit, the primary policy responds first, subject to a deductible or self-insured retention for which the builder is responsible.

Historically, most builders have obtained their liability insurance from so-called "standard insurers" with familiar names and which are subject to regulation by state insurance commissioners. Builders also have had access to non-standard insurers, who may not be admitted in a particular state. Unlike standard insurers, who can be accessed directly by most retail insurance brokers, the non-standard insurers typically must be accessed through a wholesale (excess and surplus lines) broker.

Whether standard or non-standard, liability insurers virtually always elect not to keep within their companies all of the risk of the policies they write. Rather, they transfer portions of the risk to reinsurers through a complicated structure of treaties and related agreements. The availability of liability insurance to builders and other businesses is directly dependent upon the ability and willingness of the reinsurers to take substantial portions of the risks insured. As discussed in more detail below, the current liability insurance crisis for builders is in large part a direct result of an increased reluctance and/or inability of reinsurers to shoulder building industry risks. These conditions and other factors have combined to create what knowledgeable insurance industry executives have described as a critical lack of "capacity".

Until recently, builders have had reasonably good access to a number of liability insurance structures. These structures historically provided a significant degree of flexibility to builders to match their insurance needs, business objectives, price sensitivity and appetite for retaining risk. They include conventional annual renewal programs, where the builder typically insures all of its projects and entities under a master corporate liability insurance program, renewed annually; project-specific liability policies; discontinued operations (buyout) policies; wrap-up policies; and liability policies combined with warranty coverage. These structures, as well as other coverage alternatives, are discussed in more detail below in the section entitled "Practical Suggestions for Responding to the Insurance Crisis."

REASONS FOR THE CRISIS The reasons for the current insurance crisis are complex and multi-dimensional. However, several key causes can be identified.

Underwriting Practices. Knowledgeable observers believe that the insurance industry itself is at least one source of the problem. These observers indicate that over the past decade, insurers have been charging premiums which were too low to support the risk being insured and that insurers were and are under-reserved (not setting adequate reserves for anticipated claims). This phenomenon is industry-wide, not limited to the small group of insurers writing builder policies. As a result, the builder segment of the insurance industry continues to suffer loss ratios far in excess of the premiums charged. (The average loss ratio in this segment of the industry is said to be three to four times the premium dollar.)

Out of Control Construction Defect Litigation. A major related factor specific to builders and one of the causes of the unbalanced premium-to-loss ratio, is the increase in construction defect litigation and the enormous associated costs. Generally, insurers are obligated to pay defense costs including attorneys' fees and expert expenses, in addition to the indemnity limits (i.e., defense costs are "outside the limits" of the policies). Thus insurers face a situation in which they must pay unlimited defense costs until the indemnity limits of their policies are exhausted by payment of settlements or judgments. Defense costs can and often do exceed the amount paid by insurers for indemnity. Observers indicate that for these reasons, builders as a class of business not only are unprofitable, they have become extremely costly to insurers as well.

The high cost of construction defect litigation is not the only negative, from the insurers' perspective. Only a few years ago, major construction defect litigation was for the most part limited to California, Texas and Florida. In those states, an aggressive plaintiffs' bar and a cottage industry of plaintiff-oriented consultants and experts combined to create an environment in which virtually every condominium or townhome project would be hit with a lawsuit. Today, communities of detached single-family homes are experiencing an incidence of construction defect litigation nearly as high as attached projects.

Unfortunately, this litigation trend is spreading nationwide, particularly to Nevada, Colorado, Arizona and other states. The Internet allows plaintiff attorneys and consultants, homeowners and homeowner associations (HOAs) to share information about pending claims and emerging builder liability issues. Some plaintiff lawyers establish websites focusing on particular builders and their real or perceived quality problems. At the same time, homeowners and HOAs involved in litigation with a builder share information and tactics with homeowners and HOAs at other communities built by the same builder, not just in the same local geographic area, but regionally and nationally.

This litigation trend is further fuelled by heavy media coverage and a surge in large verdicts and settlements, which of late have included awards both for property damage and bodily injury arising from claims involving mold and indoor air quality. Many insurers believe that mold and indoor air quality claims will be even more costly than the asbestos claims of the 1970s and 1980s.

Our industry's exposure profile is not helped by the fact that builders are subject to broad legal liabilities, including strict liability in some states, and long statutes of limitations or repose. Statutes of limitations are time periods designated by law within which a lawsuit must be filed. Such limitations periods extinguish the right to file a lawsuit after the statutory time period expires. In contrast, statutes of repose set outside, maximum time limits within which certain types of lawsuits can be filed. For example, in California, a plaintiff can file a lawsuit for property damage based upon alleged latent (hidden) defects as long as 10 years after completion of the project, depending upon when the damage was discovered. Florida has a 15-year statute of repose. Moreover, in some states, such as California, the statute of repose does not cut off bodily injury claims, such as those alleged to be caused by mold.

Contraction of the Reinsurance Market. The availability of insurance is driven in large part by the accessibility of relatively inexpensive and plentiful reinsurance. Another source of the insurance crisis is an overall contraction of the reinsurance market, which was well underway even prior to the September 11, 2001 World Trade Center tragedy. As losses have matured in recent years and large claims paid, loss ratios turned upside down and reinsurers began to feel the effect of insufficient premiums. The reinsurance market contracts as a result.

Decline In Investment Income. Industry observers cite the stock market decline as another significant factor. Insurers depend in large part upon income generated from investing premium dollars. The stock market decline, particularly in the technology sector, has had a dramatic economic effect on the macro economy, and the insurance industry certainly is not immune. In the past five years, insurers have experienced average returns on their investments as low as five percent. Together with large losses, low investment income translates directly into reduced capacity.

How Serious Is The Capacity Crunch? All of the foregoing factors are contributing to the insurance crisis. The World Trade Center event exacerbated the existing problems, in particular declining capacity. Industry sources define "capacity" in one respect as the ability to write insurance at a rate directly proportionate to insurer and reinsurer losses - - the amount of loss determines the amount of capacity.

The predicted amount of loss suffered as a result of September 11 is in the \$40 billion to \$70 billion range. Some believe the final tally will prove to be three to four times higher, but even assuming the lower figures are accurate, as much as one-third of the reinsurers' capacity has been taken away. It is too soon to assess the full impact of September 11, but it is clear that insurers are reacting very cautiously. On the other hand, some observers believe that insurers are overreacting and even using the September 11 events as an excuse for charging higher premiums to builders than the harder market otherwise might justify.

IS THE CURRENT CRISIS CYCLICAL? The insurance market long has been subject to its own business cycles, as overly aggressive pricing and less-stringent underwriting eventually lead to a tighter market. Thus, in some ways, the present crisis can be characterized as cyclical. The market for homebuilding insurance always has been difficult. Rarely have there been more than five to six major insurers at any one time in this sector of the insurance industry.

However, some aspects of the crisis, such as September 11, are unique. The proliferation and high cost of construction defect litigation also distinguish the present crisis from past history. Thus, while we are in a cyclical hard market, there are unique factors at work which render it more difficult to predict when and in what fashion the market will begin to turn.

EFFECTS OF THE CRISIS: THE PRESENT ENVIRONMENT The insurance crisis has affected adversely the availability, affordability and scope of liability insurance coverage for builders, as well as their trade contractors and design professionals.

Availability of Coverage for Homebuilders. In virtually all parts of the country, particularly in states with existing or emerging construction defect litigation exposures, liability insurance coverage is dramatically less available for homebuilders than it was as little as 6 to 12 months ago. Industry sources indicate that this condition prevails across the board and affects the availability of conventional (annual renewal) liability insurance, more specialized liability insurance for attached product, project-specific liability insurance policies (for both attached and detached product) and discontinued operations (buyout) policies.

For conventional liability coverage, (i.e., primary, umbrella and excess policies) written on an annual renewal basis, there has been a steep decline in the number of carriers willing to write such policies in the past 12 months. Industry sources now indicate that even builders in states without heavy construction defect litigation cannot obtain more than one or two quotes from insurers. In Florida, for example, the number of carriers currently writing insurance for residential contractors has decreased by more than 50 percent during the past 12 months, so that only four insurers remain. In other parts of the country (with some regional variations), the familiar, old-line standard insurers are no longer willing to insure builders. Those who are willing to write policies for builders have significantly decreased the limits they are willing to offer so that builders now are unable to obtain the policy limits they require.

For very large builders, the market opens up slightly if the builder is willing to take high deductibles or self-insured retentions, often in excess of \$2 million. Even with that level of risk retention, some insurers are offering indemnity coverage only (i.e., no defense). Even large public builders have recently undergone renewals in which they were able to obtain only two to three quotes, and those were at previously unheard-of premium levels.

The umbrella and excess markets likewise have constricted. The typical limits available for umbrella coverage have decreased 100 percent, from approximately \$20 million to \$10 million in limits available to be purchased. While approximately 6 to 12 months ago, builders were fairly readily able to obtain \$50 million to \$100 million in excess coverage limits, those limits no longer are available to most builders, at any price. Several sources now indicate that the only option for insurance in excess of \$25 million to \$50 million is the London market, but one could speculate whether, given the recent events of September 11 that will remain true.

The situation is even graver with regard to attached product. In some states, only 2 or 3 insurers will even consider writing insurance for condominiums and those who are willing to do so have either lower available policy limits or have imposed significant restrictions on coverage. For example, one of the few remaining insurers in the western states for attached projects will not provide coverage for buildings with more than 8 dwelling units, or which are more than 2 stories in height. While umbrella and excess insurance for attached projects was available 6 to 12 months ago, today it is virtually nonexistent, with only minor exceptions. Project-specific coverage, both for attached and detached projects, similarly has contracted. Finally, while discontinued operations (buyout) policies still are available, depending upon loss history, geography and other factors, there are only 1 or 2 markets, pricing is adverse and umbrella/excess coverage is virtually non-existent.

Affordability. Along with decreased availability and coverage limits, builders are seeing an enormous increase in premiums. Even where coverage is available, builders are experiencing premium increases ranging from 50 percent to 1000 percent. With respect to primary coverage, the average premium increase (depending upon where the builder does business) is anywhere from 50 percent to 100 percent, or more. In more adversely affected parts of the country, such as in Colorado, builders and trade contractors have experienced premium increases as high as 400 to 500 percent. (One broker reported a plumbing trade contractor whose premium increased 400 percent. The insurer's stated reason for the increase was its concern over the plumber's use of a shovel.) For umbrella and excess coverage, the increases start at 200 percent, and are sometimes as high as 1000 percent higher than 12 months ago.

Scope of Available Coverage. At the same time as insurance availability and affordability have deteriorated, the scope of available coverage has narrowed. As noted above, few markets will provide coverage for builders for attached projects. Many trade contractor and design professional policies now exclude work on attached projects (and in some cases, exclude all residential construction, a fact not always brought to the builder's attention).

At least one insurer has modified its basic liability insurance policy form so that both the "occurrence" (e.g., the alleged negligent construction) and the resulting bodily injury or property damage both must take place during the policy period. In contrast, standard liability insurance policy forms afford coverage no matter when the negligent construction was performed, so long as the resulting bodily injury or property damage occurs during the policy period. Because the resulting injury or damage typically takes place *after* completion of the project -- in many cases, years after -- this policy form affords the builder little meaningful protection against construction defect claims. The net result is that builders now may be getting coverage more akin to a claims-made rather than an "occurrence" policy.(1)

But the predominant manner in which coverage is being restricted is by the attachment of exclusionary endorsements to builders' liability policies.

Mold Exclusions. In January 2000, insurers began attaching mold exclusions to their policies. This trend has accelerated since July 2001. Some carriers have limited their coverage for mold claims to property damage, excluding any coverage for bodily injury. Others exclude mold entirely. Yet another approach by one insurer is to attach an extremely broad mold exclusion to the policy, then "give back" a limited dollar amount (in some cases, a \$100,000 sublimit) of coverage for mold claims.

Mold exclusions first were attached to policies issued in highly litigious states, such as California, but now are being attached to policies insuring builders in other states, as well. On a slightly positive note, the insurance commissioner in at least one state, Florida, has rejected a proposed mold exclusion which insurers there had begun to use.

EIFS Exclusions. Another now-common exclusion applies to builders who used or use synthetic stucco or EIFS products. Some carriers refuse to write insurance for a builder which uses these products; others simply exclude claims arising from its use, whether or not the builders no longer uses the product.

Montrose Exclusions. For several years, insurers also have limited the scope of coverage afforded through the use of “known loss” exclusions, also referred to as “Montrose” exclusions. (2) Today, Montrose exclusions are contained in virtually every liability policy.

When first used, these exclusions generally barred coverage only for known loss or damage, or for known claims which commenced prior to the inception date of the policy in question. In the past 12 months, Montrose exclusions have become even more restrictive. Now, many versions of the exclusion purport to exclude completely any continuing loss or damage, whether known or not. In other words, if the loss commenced before the inception of the policy, there would be no coverage for it.

Earth Movement Exclusions. Exclusions for earth movement and subsidence were widely used in the 1980s, but during the soft market of the 1990s, most insurers ceased attaching the exclusion. (As always, there were exceptions in high-risk states such as Colorado, Texas and California.) Now, however, the trend is to include an earth movement and subsidence exclusion in many umbrella and excess policies and, increasingly, in primary policies, as well.

Professional Services Exclusions. Even during the soft market, many insurers attached an exclusion for liability arising out of professional services (e.g., architectural, engineering, surveying) performed by, or for, the insured builder. However, builders frequently were successful in modifying the exclusion so that they could retain coverage for bodily injury or property damage arising from negligently performed professional services. Over the past 6 months, it has become virtually impossible to obtain such modifications. As a result, insurers will assert that there is no coverage for a construction defect claim to the extent it arises from the performance of professional services.

Few, If Any, Coverage Enhancements. Historically, builders have been able to negotiate language changes in their liability policies to enhance and broaden the coverage provided, or at least clarify the policy in order to avoid a restrictive interpretation later. For example, some insurers were willing to modify the wording of their Montrose exclusions and professional services exclusions. Knowledgeable brokers now indicate that such enhancements and clarifications are no longer available, except possibly for large builders on a very limited basis. Some limited exceptions to this rule do exist with respect to project specific policies and wrap-ups. The bottom line: liability insurance for builders of all sizes increasingly is becoming a “take it or leave it” proposition.

Effect on Design Professionals and Trade Contractors. Design professionals, such as architects and engineers, and trade contractors are not immune to the current crisis and have experienced many of the same availability and affordability difficulties as builders. Depending upon the geographic location in question, we are seeing design professionals carry minimal levels of professional liability (errors & omissions) insurance, typically \$1,000,000 per claim. Some design professionals simply are not carrying professional liability insurance at this time. Those who do maintain the insurance frequently are not permitted by their insurers to provide professional services for attached projects.

Trade contractors, too, are seeing decreased availability, fewer insurers willing to cover them, huge premium increases and restrictions from working on attached projects, or in some cases, from working on any residential construction. Overall, although exceptions exist, many builders are experiencing difficulty engaging design professionals and trade contractors who can provide liability insurance adequate to meet the builder’s contractual insurance requirements.

These difficulties again make wrap-up insurance programs more attractive since they allow qualified design professionals and trade contractors to perform work on residential projects, including attached projects, they otherwise could not insure. The use of wrap-ups as a coverage alternative is discussed in greater detail below.

Has the Insurance Crisis Spread Nationwide? The insurance crisis first affected builders in states with heavy construction defect exposures, including California, Texas and Florida. Recently, it has become clear that the crisis has spread nationwide, with Colorado, Arizona, Utah and Nevada now affected seriously. Premium increases are equally high in these states. In some parts of Colorado, virtually no coverage is available. States which historically have not had significant construction defect exposures are slower to feel the impact, but insurance industry sources indicate that builders nationwide will, to a greater or lesser degree, experience the same difficulties with availability, affordability and restrictive coverage. In short, the industry is in a nationwide crisis.

PROGNOSIS Knowledgeable industry sources do not believe the market will cycle back to anywhere near normal for a long period of time, due, in large part, to the lack of capacity. It was unlikely that conditions would change even after December 31, 2001 when significant reinsurance treaties were up for renewal at that time. The most optimistic scenario is that, depending upon the nature of the reinsurance picture, new insurers will enter the market, but it will take a minimum of six to 12 months to create new insurance facilities. Even under this optimistic scenario, the insurance market for builders will still be characterized by decreased availability, much higher premiums, and more restrictive coverage.

Having said that, the insurance industry is driven, of course, by the basic economic principle of supply and demand. The current crisis has resulted in a constriction of the market and higher premiums. At a certain point, however, these increased premiums will become attractive to new insurers and/or to the insurers who have ceased writing policies for builders. In the aggregate, the building industry generates too much premium volume to be ignored or underserved permanently. This is not to say that pricing will soften in the foreseeable future. The reality of higher premium levels eventually (optimistically perhaps a year or two from now) should return some level of balance to the market, absent another catastrophic event. But, for the foreseeable future, builders will continue to pay more for less liability coverage.

Two other effects are noteworthy. First, builders are being forced to retain more risk. This occurs indirectly as a result of narrower policy coverage. It also occurs directly as a result of higher deductibles and self-insured retentions which builders now must be prepared to fund.

In addition, builders should expect to see changes in the way umbrella and excess coverage fit into the builder's overall insurance program. Some industry observers believe that even after the market begins to soften, umbrella coverage will remain unavailable, or at least less available, to builders. Instead, builders will be purchasing true excess policies, which may or may not be as broad as the underlying primary policy. Builders also should expect to see excess policies structured so that they do not "drop down" after exhaustion of the underlying primary policy. Rather, excess policies increasingly will be structured so that they remain excess of a certain underlying dollar amount, whether that amount is paid by the primary insurer or not.

Builders also must plan to rely less on their liability insurance in pre-claim settings and in litigation. For example, pre-litigation claims in which the builder previously would expect its insurer and trade contractors to participate now may be required to be handled as a customer service matter, with the builder (and hopefully the trades) paying the cost. Contractual risk transfer provisions in the builder's trade contracts (indemnification, insurance and the like) will become even more important. And builders must become even more proactive in taking steps to reduce their risk of construction defect liability using non-insurance risk management tools, discussed in more detail below. Effectively applied, these tools can permit builders to take greater control of their own risk and insurance destiny.

PRACTICAL SUGGESTIONS FOR RESPONDING TO THE INSURANCE CRISIS Insurance market conditions today are extremely adverse, but there are a number of steps builders can take to help survive the crisis and best position themselves now and for the time when the market eventually begins to turn.

Strategy No. 1: Risk Management Must Be More Than Buying Insurance In the current environment, builders must approach risk management as more than simply calling their agent or broker to purchase insurance. Knowledgeable builders have long viewed insurance as an essential, but also as the most expensive, risk management tool. Now, insurance increasingly is not only extraordinarily costly, it is less available and, in some cases, unavailable.

As a result, the process of identifying and managing risk - especially using non-insurance risk management strategies - must be a core part of every builder's company philosophy and operational practice. The scarcity and cost of liability insurance make non-insurance risk management tools an economic necessity.

Each employee and executive and each operating unit within a building company has a role to play in this effort. Every stage of each project offers challenges, but also opportunities to reduce risk. As discussed below, these opportunities exist from project conception and selection of product type through land acquisition, construction, sales and post-sale customer service.

How should builders approach this broader view of risk management? Builders are urged to follow a four-part strategy:

- Avoid liabilities.
- Minimize liabilities.
- Shift liabilities to other parties.
- Insure liabilities.

A detailed discussion of this four-part strategy is beyond the scope of this paper. However, by way of example, certain liabilities can be *avoided* or *minimized* by product selection decisions (e.g., electing to build only detached residences rather than higher-risk condominiums and townhomes). Liabilities can be *shifted* to other parties by contractual risk transfer provisions, such as insurance, indemnification and "compliance with laws" provisions in trade contracts and design professional contracts, for example.

Job site injury claims offer a prime example of how non-insurance risk management can work for builders. Although construction is statistically a high-risk industry in terms of worker injuries, builders can achieve remarkable safety results by designing, implementing and enforcing strict loss prevention and safety programs for their projects. Assisted by knowledgeable insurance brokers and safety consultants, many builders have been able to enlist their trade contractors and vendors in minimizing costly workers' compensation claims and so-called "actions over" by injured trade contractor employees against the builder. (3) All of this translates into fewer claims and better loss experience, which makes the builder more attractive to workers' compensation and liability insurers.

There are several specific steps builders should take in this new environment.

- **Identify Potential Loss Exposures.** In this "radar screen" step, the builder monitors its operating environment for liability risks and exposures. While construction defect claims are a driving force behind builders' current insurance difficulties, especially in the western states, they are not the only risks which must be assessed and managed. Others include job site safety, environmental and pollution risks, employment liability and consumer non-disclosure claims.
- **Prioritize Loss Exposures.** Here, the builder evaluates risks in order to set priorities. Frequent, but non-severe losses (such as minor employee injury claims) are assigned a different priority and treatment than major construction defect or environmental liability claims, which are of lower frequency, but higher severity.

- Select The Right Risk Management Tools. This step requires business judgment and experience. For example, avoiding or minimizing liabilities by not building condominium projects may be the safer course, but unrealistic in light of the builder's financial objectives and market needs. Rather, the builder may decide that while construction defect liabilities in such projects cannot be entirely avoided, they can be minimized or reduced by effective quality control ("QC") programs, as discussed below.
- Implement The Program And Evaluate Results. This step probably requires the most discipline on the part of the builder. First, the risk management program must be properly documented by revising contracts, consumer sales documents, new home warranties, contract administration checklists, in-field construction procedures and customer service guidelines. Second, the builder must recognize that changes of this magnitude create business tensions. As a result, the builder will need to "sell" its new, broader risk management concepts to its own employees, its trade contractors, design professionals and vendors, and its consumers. Third, implementing the program typically will require some structural and personnel deployment change within the building company. For example, small to medium-size builders, or builders who do not have a professional risk manager on staff, will need to determine the appropriate executive to quarterback and be accountable for risk management programs. This executive, in turn, will need to quickly assess the need for assistance from outside experts (QC consultants, insurance brokers, risk management legal counsel).

Finally, the builder must measure the effectiveness over time of its risk management initiatives and apply what is learned so that its components are continually updated and improved. This step requires patience. The results of new risk reduction initiatives may not be immediately apparent. At least initially, success may be largely hidden. But experience teaches that some results can be apparent quickly. Some examples:

- The board of directors of a condominium community voted to file a construction defect lawsuit against a prominent local builder, but without canvassing the individual homeowners or giving the builder a fair opportunity to inspect and address the claimed construction problems. In response, the builder performed direct outreach to the individual homeowners and made clear its commitment to resolve any legitimate construction issues. Understanding that their community could be stigmatized by a major construction defect lawsuit, and that their individual home values could suffer, the homeowners forced a special election and recalled the rogue board members.
- A regional builder of high-end detached residences used a consumer sales agreement that contained protective provisions such as a waiver of jury trial, mandatory arbitration and no attorneys' fees provision. A potentially significant construction defect allegedly was present in a number of the homes in the community, which attracted the attention of a plaintiff's lawyer who solicited all of the homeowners. When the lawyer learned that he could not take the claim before a jury and had no opportunity to recover attorneys' fees from the builder, he and the homeowners lost interest and the problem was resolved successfully as a customer service matter.
- A national public builder obtained from its QC consultant and outside risk management legal counsel a quantitative and qualitative analysis of the additional level of risk presented by building attached product, rather than detached homes, in a proposed new community. The analysis permitted the builder to understand and weigh the amount of marginal risk presented by building attached product. Specifically, the study measured the potential cost to the builder if certain typical defects were present in the homes and a suit was filed, versus the cost of *preventing* the defects by a program of improved design and strict construction inspections. As a result, the builder was empowered to make a rational business decision based upon what the builder called a "dollars not lost" analysis.
- A smaller builder had been lax in collecting certificates of insurance and additional insurance endorsements from its trade contractors. When the endorsements were reviewed, the builder learned to its surprise that it was being given non-complying endorsements which did not afford the builder proper additional insured status on the trade contractors' liability insurance policies. As a result, the trades' insurance would be of little or no value to the builder in the event of a construction defect claim. After training by the builder's insurance broker and risk management legal counsel, an accounting department employee now is armed with the knowledge and authority to review and, if necessary, reject non-complying certificates and endorsements. As a result, compliance has increased to over 90%.

Strategy No. 2: Builders Must Make Themselves More Attractive To Insurers As we noted above, less than optimum past underwriting by insurers is a factor in the present liability insurance crisis for builders. But that already has begun to change. Today and in the future, we are convinced that insurance underwriters will expect builders who wish to qualify for coverage to have in place comprehensive programs crafted to avoid, minimize, or shift risks, especially construction defect risk.

Regardless of where they are on the learning curve, the builder's objective is to create programs that are systematic, routinized and capable of being consistently applied and evaluated from project to project, division to division and state to state. In fact, sophisticated builders have taken a cue from Total Quality Management ("TQM") initiatives used in other businesses, such as the automotive industry. That is, each step in the risk reduction program is regularly evaluated and upgraded so that the builder achieves a "continuous loop" of process improvement.

Currently, two of the very few insurers willing to consider builders in California and other high-risk states expect to see at least the following elements in place as part of the builder's construction defect risk management program.

Risk Transfer Provisions In Trade And Design Professional Contracts. Builder contracting practices vary widely. Sophisticated builders use standardized trade and design professional contracts with strong risk transfer provisions in favor of the builder. In the current environment, builders who are not using such documentation (and who do not update it annually) must begin to do so for their own protection and to meet insurer requirements.

Well-drafted trade and design professional contracts must contain certain key risk transfer provisions. At a minimum, they should include broad indemnification language, detailed insurance requirements, a strict requirement that the other party must comply with laws and the contract documents, and detailed performance standards. Additionally, builders need to avoid certain contract pitfalls, such as an overly narrow scope of services, a performance standard which does not at least meet the applicable standard of care, disclaimers of responsibility, "reverse indemnities" whereby the trade contractor or design professional attempts to have the builder provide indemnity, and provisions limiting the design professional's liability to the amount of the fees or some other unrealistically low amount.

Quality Control During Design And Construction. To be most effective, the QC program must be tailored to the project. At a minimum, builders must now perform a review of plans by a qualified forensic architect or consultant and conduct forensic inspections during construction of a statistically appropriate sample of homes. Protocols will differ depending upon product type, geographic location, price points, and the like. Some builders engage project design professionals or third party forensic consultants to certify that the approved plans and specifications have been followed, that the final grading is consistent with the approved plans and that concrete was placed appropriately and has cured properly.

Effective Contract Administration. Builders must establish systems to enable them to track compliance with contractual insurance requirements and to ensure that key contractual risk transfer provisions are not modified or diluted without the approval of senior management. Effective record retention policies also are important to assure that insurance information and project documents can be retrieved when needed. (4)

Protective Provisions In Project Documents. Ideally, the builder's project documentation (sales contracts, warranties and governing documents such as CC&Rs) will include protective provisions. These can include alternative dispute resolution ("ADR") provisions, such as mediation and binding arbitration, with a waiver of jury trial. This allows the builder and the consumer to benefit from resolving disputes more rapidly and with less cost than a civil lawsuit. Other important provisions include notice to the builder of claimed defects and builder right of access, inspection, testing and repair, builder opportunity to correct claimed defects prior to a suit or arbitration, and provisions imposing consumer obligations regarding inspection and maintenance. Anti-fraud provisions (e.g., disclaimer of any representations by salespeople) and disclaimers also should be addressed.

Proactive Customer Service. Effective customer service can make or break a builder's construction risk management program. Until now, insurers generally required only confirmation of an ongoing post-sale customer service program. However, industry observers indicate that insurers will place a greater emphasis on customer service. Insurers will be looking for builders employing well-trained customer service representatives who respond in a timely fashion, protocols for rapid mobilization of the appropriate trade contractors, and good record keeping, among other things.

Builders also should consider other risk reduction tools beyond those which are of current interest to insurers. A detailed discussion is beyond the scope of this paper, but several of these tools deserve comment.

Entity Structuring And Dissolution Strategies. In many states, builders are permitted to operate through limited liability companies ("LLCs"), which can combine the tax efficiency of a partnership with the liability-limiting features of a corporation. One widely used approach is for the builder to create a single-purpose LLC for each project, with other entities providing the LLC with contracting, accounting and other services via a development management agreement. While LLCs offer numerous advantages, they still require the builder to respect the separateness of the entity by observing corporate formalities, such as maintaining separate bank accounts and carefully documenting inter-company loans or other transactions. These steps are essential to avoid alter ego and enterprise liability attacks, which a claimant might assert to "pierce the corporate veil" and reach the assets of the members or affiliated entities.

Regardless of which type of entity the builder selects, there are important questions to be answered about when to dissolve the entity, including who will perform customer service and warranty work after dissolution, whether adequate completed operations ("tail") liability insurance coverage can be purchased for the dissolved entity and similar risk management issues.

Homeowner And HOA Maintenance Manuals. A number of proactive builders use outside consultants to assist them in preparing homeowner and HOA maintenance manuals, tailored to the particular product type. These manuals offer an opportunity for education, for disclosure and for management of homeowner expectations. Ideally, the manual should be tied to the new home warranty provided by the builder so that there is a common roadmap that both the homeowner and the builder expect to be followed. As discussed below, if the builder elects to include a binding arbitration provision in its new home warranty, the combination of the manual and the warranty can become a powerful defensive tool which channels homeowner disputes into the customer service process and, if the dispute is not resolved there, into mediation and binding arbitration.

Protective Provisions In New Home Warranties. Builders' new home warranties often are underperforming risk management assets. Rather than continue to use an off-the-shelf warranty document, which may have been stitched together over time, builders should take a fresh look at their warranty as a risk management tool. (5) Depending upon state law, the builder may be permitted to require resolution of disputes through mediation and arbitration, rather than costly jury trials. Such an ADR provision may be included in the warranty (as well as in, or instead of in, the consumer sales documents). If this is the case, the builder may want to consider expanding the coverage afforded by the warranty and perhaps even extending its duration.

Another area where most warranties can be improved is to include a clearer roadmap of warranty claim procedures, perhaps with specific timeframes, and to apply them consistently. Critically, the warranty document must disclaim all implied warranties, to the maximum extent permitted under state law. Many warranty forms used by builders probably do not contain a legally adequate disclaimer, thereby leaving the builder needlessly exposed to implied warranty claims.

Tap Into Expert Resources. Building industry experts, such as insurance brokers, QC consultants, and outside risk management, and insurance coverage counsel who represent builders, are useful contacts for risk management suggestions. They also can be sources for training and educational programs.

Strategy No. 3: Consider The Available Coverage Alternatives Notwithstanding the current crisis, a number of coverage alternatives are available and should be considered.

Pursue Existing Insurance Structures While They Are Still Available. The window of opportunity may or may not close, but builders should investigate project-specific policies and discontinued operations (buyout) policies while these alternatives are still available. Project-specific liability policies provide a single liability insurance policy for a one-time up front premium, with limits of liability dedicated to a specific project. Typically, project-specific coverage includes a primary policy and umbrella or excess coverage furnishing additional limits. These policies can be structured so that they remain in effect for a specified period after construction, or until all potential claims are barred by statutes of limitations or repose. This extended completed operations coverage is important because in some states, such as California, liability extends beyond the statute of repose. Project-specific policies have been used on both attached and detached projects. They can be written to insure only the builder, or they can be written to insure the builder and its trade contractors, akin to a wrap-up policy, discussed in more detail below.

In addition, the purchase of a discontinued operations policy should be considered as a way of isolating losses on past projects and creating more of a clean slate which will be attractive to an underwriter when evaluating go-forward liability coverage. A buyout policy can, for a one-time up-front premium, cover the builder's completed operations exposure for a single project, for a group of projects, or for all of the builder's past projects. This structure allows the builder to place past projects and exposures (particularly construction defect exposures) into a separate insurance "bucket". Buyout policies must include a completed operations coverage extension so that the insurance applies for an agreed-upon period into the future (ideally, until claims are barred by statutes of limitations or repose). Some builders have found these to be attractive because they allow the builder to quantify today the cost of insuring past projects, rather than be at the mercy of the market in future years. As discussed below, this structure is another way builders can make themselves more attractive to underwriters.

Consider Wrap-Up Policies. In an owner-controlled insurance program (OCIP, a.k.a., "Wrap-Up"), the builder procures the liability insurance for itself and the trade contractors. The trades bid the job without insurance costs, thus allowing the builder to recoup at least some of the cost of the program by obtaining "insurance credits".

Many knowledgeable insurance industry executives view wrap-ups as the wave of the future for builders. If trade contractors are unable to obtain adequate insurance of their own and unable to provide proper additional insured status to the builder, a wrap-up may be the only way builders can pursue their business plans, particularly construction of attached projects.

Wrap-ups are extremely flexible and can be written for single projects, a group of projects, or for all of a builder's projects continuing over time (a rolling wrap-up). Wrap-ups offer the advantages of greater purchasing power, extended completed operations coverage, and streamlined claims handling by a single team of defense counsel and experts to defend construction defect claims. In addition, wrap-ups typically have afforded builders an opportunity to modify the policy forms in order to enhance and broaden coverage and obtain coverage which otherwise may be unavailable (e.g., trade contractors increasingly are unable to obtain their own insurance and, even when such insurance is available, coverage is severely restricted). The ability to obtain such enhancements will depend upon the size of the project, whether the program is a rolling wrap-up, the amount of premium volume generated and other factors.

Another positive feature of wrap-ups is that design professionals often can be included as insureds. However, they are covered only to the extent that the claim involves bodily injury or property damage. In other words, the wrap-up will not provide pure errors & omissions coverage without bodily injury or property damage. An alternative for covering the pure errors & omissions exposure is a project-specific professional liability policy, procured by the builder or the architect and covering the project design professionals.

Wrap-ups do present challenges. These include the up-front costs, the need to educate trade contractors and design professionals about program coverage and administration, integration of the wrap-up coverage into trade contracts and design professional contracts, collection of insurance credits, willingness of the builder to handle some level of administrative burden, and heightened concerns about insurer solvency because only one insurer is providing coverage for all of the enrolled parties.

Liability Policy Combined with Warranty Coverage. Another alternative combines liability insurance coverage with coverage for warranty claims. Under one such structure, the liability insurance is provided by one company and the warranty coverage by another, but they are sold to the builder as a package. A innovative policy structure could combine general liability insurance and warranty coverage in a single insurance policy. It can be structured as a wrap-up and offer broader coverage and higher limits than most builders can typically obtain.

The current insurance crisis has affected the availability, affordability and scope of coverage under all of the above alternatives. The specific effects vary from state to state, depending upon the perceived or real level of construction defect risks. Nevertheless, the consensus among the insurance industry experts consulted is that builders nationwide will, to differing degrees, feel the effect of this crisis.

To Address Narrower Coverage Under the Liability Policy, Consider Other Specialized Policies. Certain of the exposures which increasingly will be outside the coverage of the builder's general liability insurance policy can be addressed by other specialized types of insurance policies. Some key examples follow.

- *Contractors Pollution Liability Insurance.* This coverage can be tailored to provide builders with coverage for bodily injury and property damage resulting from releases of "pollutants" from the project site and arising out of the builder's operations. This coverage is important to builders performing due diligence or construction operations on any parcel with environmental risk, such as urban in-fill sites, brownfields properties and former military bases. Equally important, the policy can provide coverage for mold claims which are excluded under the builder's general liability policy. This policy offers a non-standard type of coverage, so insurer policy forms vary and require review and possible modification. It is preferable to obtain this coverage on an occurrence basis rather than on a claims-made basis.
- *Contractors Professional Liability Insurance.* This coverage can be used to protect the builder from construction defect claims arising out of professional services performed by others. Typically, these claims now are excluded by the builder's general liability policy. This coverage only protects the builder, not design professionals, and it is not intended as a substitute for professional liability insurance to be carried by design professionals. Again, this is a non-standard form of coverage, so policy forms vary and will require tailoring.
- *Employment Practices Liability Insurance.* This coverage focuses on wrongful termination, workplace discrimination, harassment claims and other employment disputes. It addresses the gap created by employment practices exclusions in the builder's general liability policy. This coverage is of increasing importance for two reasons. First, the building industry historically has had fewer employment practices claims than other industries. Statistically, this is likely to change. Second, with some areas of the country already in a recession and a national economic slowdown apparent, there may well be reductions in force at building companies. These will be the source of more employment-related claims.
- *Real Estate Agent/Broker Errors & Omissions Insurance.* General liability insurers routinely refuse to defend or indemnify builders in consumer lawsuits alleging non-disclosure, usually due to the lack of alleged bodily injury or property damage. Often, the builder's salespeople are the alleged source of the non-disclosures or misrepresentations. This policy can be adapted to protect the salespeople and possibly the building company, as well, against such claims.

Consider the Use of Captive Insurance Companies and Risk Retention Groups. When the insurance market hardens to this degree, captives and risk retention groups become increasingly attractive as a vehicle for obtaining liability coverage. Captives are insurance companies controlled by their owners, who typically supply all of the captive's business. The shareholders of the captive are also insureds. They participate in underwriting, claims and investment decisions. When properly structured and administered, captives can create access to reinsurance markets, reduce claim expenses, provide risk management expertise and offer more flexibility and broader coverage than traditional insurance products.

Group captives are owned by a group of non-affiliated entities. Risk retention groups are a form of group captive, organized under the federal Liability Risk Retention Act of 1986. It is possible for an industry association, such as NAHB, to form its own "association captive", limiting access to coverage to association members. Another alternative is a so-called "rent-a-captive", owned by a third party entity which is not an insured but rather is a broker, reinsurer or fronting insurance company.

Strategy No. 4: Builders Should Use The Resources Of Knowledgeable Insurance Brokers

Insurance brokers have an important role to play in helping builders through the current crisis. However, to do so, the broker must have a high level of building industry knowledge and experience, as well as access to all potential insurance markets. For most retail brokers, this requires a relationship with a well-connected wholesale (or excess & surplus lines) broker who can access both national and international insurance markets so that all possible insurance alternatives are in play.

A knowledgeable retail insurance broker can assist the builder in numerous ways, including the following:

Evaluating The Builder's Insurance Needs And Potential Coverage Alternatives. A key broker function is to understand the builder's business in order to be able to evaluate the builder's insurance needs and match the available alternatives to these needs. In today's volatile market, builders require broker assistance to understand the terms and conditions being offered to them by the insurers, the residual uninsured exposures and possible alternatives for covering them, and the effect on the builder of retaining more risk.

For example, an experienced broker can "game out" various risk retention scenarios (deductible versus self-insured retention, umbrella versus excess insurance coverage, higher attachment point for excess coverage, and the like). In this way, the broker can help the builder make the business decision of how much risk the builder can and should retain, and the appropriate manner in which to do so. At the same time, the builder will look to its broker to advise on changing insurance market conditions and coverage alternatives, including the crucial issue of insurer financial solvency.

Promoting Relationships With Underwriters. Sophisticated builders treat their relationships with insurance underwriters in much the same way as they would relationships with their lenders and investors. By analogy to initial public offerings, the broker must be prepared to help tell the builder's "story" to the underwriters. Among the key points: Why is this builder a good risk for the underwriter to insure? What about this builder makes it unique in its approach to managing risk? What risk reduction steps has the builder taken and what have been the results?

A closely related concept is that the relationship with the underwriter should not start and end at the time of insurance renewals. All things being equal, builders are best served by maintaining longer-term relationships with underwriters, which are based on generating a meaningful volume of premium volume over time. In today's market, long-term relationships are exceedingly difficult, but a number of builders have benefited from them.

Due to the need to shore up or build relationships with the underwriters, knowledgeable brokers will tell their builder clients to begin preparation for insurance renewals much earlier than in prior years. The few remaining underwriters who will entertain builder coverage are inundated with applications. As a result, the broker needs as much lead-time as possible to obtain pertinent information from the builder and assemble a persuasive submission for the underwriter. This will include not only the typical information, such as loss history, anticipated sales and revenue volume, pro forma construction values, recap of past projects, anticipated future projects, and the like. Now, it is equally important to include in insurance applications detailed information about the builder's QC programs and other risk reduction tactics it employs.

Presenting The Builder's Claims History In The Best Possible Light. A knowledgeable broker can assist by explaining to the underwriter the builder's claims history. If that history is good, the broker can explain why. For example, the builder may be reaping the benefits of long-term relationships with a stable group of trade contractors and the talents of experienced superintendents, all of which tends to result in higher quality construction and fewer claims. Similarly, the builder may have an outstanding customer service operation that has kept small problems from becoming lawsuits.

If the builder has had losses, they need to be explained. Perhaps they were attributable to one-time events, such as a hurricane, tornado or earthquake. Or they may be explainable as resulting from poor design by an architect the builder no longer uses or failure of a product the builder has eliminated from later projects. Or the builder may have purchased a discontinued operations policy to cover past projects, so that construction defect claims on those projects will not implicate the builder's future liability insurance policies.

Assisting In Non-Insurance Risk Management Efforts. A sophisticated broker can go beyond procuring insurance. The broker can assist the builder with loss control and safety expertise, claims handling assistance, input to the builder's counsel in revising construction contracts, and assisting in implementing programs for obtaining proper certificates and additional insured endorsements from contractors and design professionals.

CONCLUSION Builders nationwide are confronting a liability insurance crisis. It is unclear at this time when, and to what extent, the insurance market will begin to turn. As a result, builders are urged to approach risk management as more than simply buying insurance and instead, employ strategies to avoid, minimize and/or shift liability risks. Builders must make themselves more attractive to insurers by improving risk transfer provisions in their construction documents, employing advanced QC programs and including protective provisions in their consumer sales documents and new home warranties. Builders also should evaluate the available coverage alternatives, consider other specialized coverages and investigate the use of captive insurance companies and risk retention groups. Finally, builders' insurance brokers can play an important role in assisting builders in this difficult environment. Aggressive use of these and other strategies will help builders position themselves to survive the crisis so that they can devote their energies to the business of building.

ENDNOTES

(1) This example is symptomatic of a trend among insurers to use their own liability insurance policy forms. Generally, these forms are modeled upon standard Insurance Services Office ("ISO") forms, but contain language modifications which narrow the coverage afforded. The lesson: policy forms and endorsements must be reviewed carefully so that the builder is knowledgeable about the coverage it is obtaining, or, as in the above example, not obtaining.

(2) The "Montrose" exclusion derives its name from *Montrose Chemical Corp. v. Superior Court*, 10 Cal.4th 645 (1995), a decision of the California Supreme Court holding that in a claim involving continuous injury or damage, coverage under multiple successive liability policies might be triggered for the same lawsuit. In an effort to avoid this so-called "multiple coverage trigger", insurers began to attach exclusions to their policies excluding coverage for continuing injury or damage which started, or was discovered, prior to the commencement date of their policy. Montrose exclusions can be viewed as an effort by insurers to force defense and indemnity obligations in continuing damage cases back onto liability insurers for prior years.

(3) In virtually all states, the injured employee's sole remedy against his employer is workers' compensation benefits. However, the builder can be subject to a direct lawsuit (an "action over") by the injured employee because the builder does not enjoy the same "exclusive remedy" protection as the employer. Under this scenario, the builder's own general liability insurance policy is required to respond to the injured employee's claim, which then becomes a part of the builder's loss history.

(4) For a more detailed discussion and checklist, see "Implementing Effective Record Retention Policies for Developers" (*Journal of Construction Accounting and Taxation*, Summer 1995).

(5) For a more detailed discussion and checklist, see "New Rules: Gaps and Gaffes in New-Home Warranties Uproot the Old Playing Field" (*Big Builder*, September 2001).

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