

Piper Rudnick



**WHITE PAPER ON RISK
TRANSFER FOR TRADE CONTRACTORS**

**Prepared for the
National Association of Home Builders**

**Stephen R. Mysliwec, Esq.
PIPER RUDNICK LLP**

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Introduction

The purpose of this paper is to help trade contractors understand the fortuitous risks of construction activities that they are responsible for and the methods available to them for managing such risks. A dramatic increase in construction defect litigation and an equally dramatic decrease in the availability of liability insurance is forcing builders and trade contractors alike to find alternative ways to deal with construction risks. Builders are increasingly shifting the risk of fortuitous construction losses to their trade contractors. It is important for trade contractors to understand why this is happening, to know what is and what is not covered by their liability insurance policy, and to manage fortuitous risks in a world where liability insurance no longer plays the role it once did in protecting the trade contractor from such losses.

I. UNDERSTANDING THE ALLOCATION OF CONSTRUCTION RISKS

Business is risky. Doing business in the home building industry is no exception. The potential rewards of being a home builder, trade contractor, or other member of the home building industry are accompanied by the risk of failure. Some of the risks involved in home building are “business” risks. Decisions regarding which builder or trade contractor to do business with, the kind of tools and equipment to buy, the type and brand of building materials to install, or whether to hire a new foreman or crew in order to increase productivity -- all present opportunities for success or failure that the builder or trade contractor tries to control through the exercise of sound business judgment.

Other risks -- known as “fortuitous risks” -- present a chance of loss only and are often less subject to the builder’s or trade contractor’s control. Fire at the construction site, injuries to employees, latent defects in building materials, or poor workmanship by an employee or subcontractor are examples of such fortuitous risks that can harm any builder or trade contractor. It is important to the success of trade contractors that they understand such risks and know how to manage them.

A. The Changing World of Risk Allocation

With respect to most fortuitous losses, builders and trade contractors decide in advance, through their contracts with each other, with the home buyer, and with third parties, who will bear the risk of such losses. This is called “risk allocation.” Parties can in general allocate the risk of fortuitous loss in any way they choose, but often they decide to place the loss on the party who is in the best position to avoid or minimize the loss. For example, a builder may give the home buyer a warranty -- i.e. agree to bear the loss -- covering defects in design, workmanship, or materials. The builder may insure this warranty through general liability insurance or through insurance provided by a home buyer’s warranty insurance company. In addition to such insurance, the builder may require the architect, trade contractor, or product supplier responsible for the loss to reimburse (i.e. “indemnify”) the builder for any such losses.

As many builders and trade contractors have learned in the last two years, the patterns of such risk allocation are changing. Two interrelated developments are putting enormous pressure on home builders to take new steps to manage the fortuitous risks of

construction. The first development is the dramatic increase in lawsuits by homeowners seeking damages for allegedly defective construction. The flood of lawsuits alleging property damage and/or bodily injury resulting from mold is a good example of this trend. Such lawsuits are especially prevalent in certain states, such as California, Texas, and Florida, and they are spreading to other states, particularly Nevada, Colorado, and Arizona. Lawsuits are also common with respect to certain types of construction, such as attached multi-family units.

The second development is that builders are finding it increasingly difficult to buy general liability insurance to cover the costs of defending such lawsuits and of paying for any judgments or settlements. Even when such insurance is available, builders are paying exponentially higher premiums for policies containing lower limits and higher deductibles. Insurers are also narrowing the scope of coverage by including new exclusions, such as exclusions for property damage caused by mold, by synthetic stucco (“EIFS”), or by soil subsidence, or exclusions for progressive property damage (e.g. mold or wood rot) that began before the insurance policy’s inception date. The reasons for these changes in the insurance market are several -- (i) recent losses suffered by insurers as the result of an increase in construction defect litigation; (ii) recent losses suffered by insurers as the result of other claims, especially claims related to September 11; (iii) the decline in profitability of insurers stemming from relatively low premiums in the recent past, even before September 11; (iv) the decline in value of the insurance industry surplus caused by the investment market decline; and (v) the difficulty that liability insurers are

having finding affordable “reinsurance,” by which they distribute the risks they cover to other insurers.

Builders are responding to the increased risks of construction litigation and the decreased availability of affordable liability insurance in a number of ways. Builders are placing a heightened emphasis on quality control during construction and on customer service after the sale. They are working to become more attractive risks to insurers, in part by selecting trade contractors with strong records of quality construction, responsive customer service, strong financial stability, and adequate liability insurance. And builders are using their contracts with trade contractors to allocate fortuitous losses to the trade contractor and to impose requirements on the trade contractor that enhance the builder’s ability to obtain liability insurance.

Tip: Trade contractors with strong records of quality construction, responsive customer service, strong financial stability, and adequate liability insurance will find themselves increasingly in demand by builders, who are being forced to manage risks by means other than insurance.

B. Allocation of Risk in the Contract Between a Builder and Trade Contractor

Builders enter into written contracts with their trade contractors to record the terms of their agreement, to avoid misunderstandings, and to allocate the risk of fortuitous losses between the builder and the trade contractor. The parties are generally free to negotiate the allocation of such risks as they see fit, but contracts between a builder and trade contractor often address similar issues in similar ways. The American Institute of Architects publishes a form of contract for use between contractors and subcontractors

(AIA Document A401-1997) that is very detailed and very thorough. Many home builders, even the largest ones, tend to use shorter forms, which are less complicated than the AIA form, but which generally address particular areas of importance.

Although the details of who will be responsible for fortuitous losses that occur during or after construction are subject to negotiation, in general the builder will ask the trade contractor to be responsible for those risks that the trade contractor is in the best position to minimize -- i.e. losses associated with the trade contractor's workmanship and materials. The builder's insurance company may also require the builder to include such risk-shifting provisions in the builder's contract with its trade contractors. The principal risk allocation provisions of the contract between a builder and trade contractor involve warranties, indemnification, insurance for the trade contractor, and adding the builder as an "additional insured" on the trade contractor's insurance policy.

- **Warranties.** The contract may require the trade contractor to warrant its work against defects in workmanship and materials for a specified period of time, for example, for 10 years in the case of structural elements and one or two years in the case of other work. The trade contractor may also be required to respond quickly to a warranty claim involving its work, e.g. within eight hours in the event of an emergency plumbing, electrical, or heating/cooling problem, and within 48 hours of other problems. The contract may require the trade contractor to repair defects in its work at its own expense, and to repair any other damage caused by defects in its work. In addition, the contract may require the trade contractor to be liable for any damages incurred by the

builder, by the homeowner, or by others as the result of a breach of the trade contractor's warranty. Finally, the contract may require the trade contractor to forward to the builder or to the homeowner any manufacturer warranties on equipment or materials installed by the trade contractor.

- **Indemnification.** The contract may require the trade contractor to pay for the defense of the builder if a claim is asserted against the builder arising out of or in connection with the contractor's work, and to reimburse the builder for any settlement or judgment the builder is required to pay as the result of the claim. A builder may seek to impose broader indemnification obligations on the trade contractor, such as indemnification even for liabilities not associated with the trade contractor's work. Such forms of indemnification are against the law in certain states. In any event, a demand for such broad indemnification is subject to negotiation by the trade contractor. An indemnification provision will usually impose liability on the trade contractor that is broader than the trade contractor's liability under the contract's warranty provision. For example, indemnification could apply even if the trade contractor's warranty had expired. A demand for indemnification by the builder may entitle the trade contractor to certain legal rights, even if they are not spelled out in the contract (e.g. the right to defend and/or settle the claim against the builder, or to approve the amount of a settlement). Hence, the trade contractor will want to obtain advice from its lawyer if it receives notice of a claim or a demand for indemnification from the builder.

Tip: Trade contractors may negotiate with the builder regarding the breadth of the requirement in the contract that the trade contractor indemnify the builder for losses incurred by the builder.

- **Insurance.** The contract may require the trade contractor to buy insurance.

Through such insurance, the builder is assured that funds will be available to satisfy any judgment against the trade contractor in favor of the builder, the homeowner, or a third party. The availability of insurance for the trade contractor makes it more likely that the trade contractor will have funds to fulfill its warranty and indemnification obligations to the builder, and makes it less likely that a homeowner or other party will be required to sue the builder for injuries or damage caused by the trade contractor's work for which the builder may remain legally responsible. The contract will typically require the trade contractor to maintain worker's compensation insurance to cover injuries to the trade contractor's employees, automobile insurance for the trade contractor's vehicles, and general liability insurance for claims and lawsuits against the trade contractor. The contract may also require that the trade contractor's insurance remain in effect until final completion of the trade contractor's work, and that it include certain specified types of coverages. For example, the contract frequently requires that the trade contractor's liability insurance contain "completed operations" coverage so that even claims or lawsuits brought long after the trade contractor's work is completed may be covered by the policy. Finally, the contract may require the trade contractor's insurer to "waive its right of subrogation," meaning that the insurer cannot seek reimbursement from the trade

contractor or builder for any amounts the insurer pays out on the trade contractor's behalf.

- **The builder as “additional insured.”** In addition to requiring the trade contractor to obtain liability insurance for itself, the contract may require the trade contractor to obtain liability insurance for the builder to protect the builder against any claims or lawsuits against the builder arising out of or in connection with the trade contractor's work. In fact, the builder's own liability insurer often requires the builder to obtain such liability insurance for itself from its trade contractor. This is accomplished by adding the builder as an “additional insured” on the trade contractor's liability policy. The contract may also require this “additional insurance” to be “primary and noncontributory,” meaning that it will cover the builder in place of (not together with) the builder's own liability insurance. This prevents erosion of the insurance limits of the builder's own policy and protects the builder from an increase in premium that may result from claims made against its policy.

- **Certificates of Insurance.** The builder typically requires the trade contractor to provide evidence that the trade contractor has obtained the necessary insurance policies and has added the builder as an additional insured on the trade contractor's liability policy. In fact, the builder's own liability insurer often requires the builder to obtain such evidence. Evidence of insurance usually takes the form of a “certificate of insurance,” which is a one-page document, generally issued by the policyholder's insurance agent, that describes the insurance that the policyholder has in

place. The builder may instead require that the trade contractor provide a copy of the actual insurance policy, because it is the language of the actual policy that counts. In either case, the trade contractor's insurance agent, for no additional fee, will provide such certificates or policies to third parties upon request.

* * *

Tip: The trade contractor may use these same risk-allocating provisions in its contract with its own subcontractors, thereby assuring that the ultimate responsibility for the loss is placed on the party in the best position to avoid the loss.

II. ROLE OF INSURANCE IN MANAGING THE TRADE CONTRACTOR'S RISKS

Whether or not required by the contract with the builder, the prudent trade contractor will carry insurance to protect itself from fortuitous risks during and after construction. The principal types of insurance by which the trade contractor protects itself from such risks are builders risk insurance, workers compensation insurance, automobile insurance, and general liability insurance.

- **Builders risk insurance** is property insurance that covers the risk of fortuitous loss or damage to the trade contractor's work, materials, tools, and equipment during construction. The owner or builder will sometimes provide such insurance to cover the work of the builder and all the trades on site. Such a policy generally contains a waiver of subrogation clause, by which the insurance company waives its ability to seek reimbursement from any insured for amounts it pays for loss or damage to the property or work of another insured.

- **Workers compensation insurance** is required by almost all states to provide a source of compensation for injured employees, regardless of whether the employer was at fault for their injuries. In return, state law limits the amount of damages the injured employee may recover, and prohibits the employee from bringing suit against the employer. The injured employee of a trade contractor, however, may sue the builder, who may then seek insurance coverage for the suit as an “additional insured” on the trade contractor’s general liability policy. As discussed below, courts are frequently asked to resolve disputes about whether the builder is covered as an “additional insured” on the trade contractor’s policy for such suits.

- **Automobile insurance** provides insurance coverage for damage to a trade contractor’s vehicles and provides a defense and indemnity for any suits brought against the trade contractor as the result of the operation of the trade contractor’s vehicles.

- **General liability insurance** is the primary component in the trade contractor’s insurance arsenal. It is important for the trade contractor to understand what risks this insurance covers and does not cover. A more detailed discussion of general liability insurance is included in the section below.

- **Excess or umbrella insurance** provides greater limits of insurance than the “primary” insurance policy. Excess insurance generally incorporates the terms and conditions of the primary policy. Umbrella insurance also provides limits of insurance in excess of the primary policy but often provides broader coverage than does the primary policy. Excess and umbrella insurance are most often used to increase the limits and

expand the coverage provided by general liability insurance, but such policies can also be purchased to increase the limits of other types of insurance.

A. General Liability Insurance -- What Protection is a Trade Contractor Buying?

The insuring agreement in a general liability policy provides insurance coverage for sums that the policyholder becomes “legally obligated to pay as damages” because of “bodily injury” or “property damage” that takes place during the “policy period” and is caused by an “occurrence,” if none of the policy’s “exclusions” from coverage is applicable, and if the policyholder complies with the policy’s several “conditions.” The following are the key terms, exclusions, and conditions in a general liability policy that usually determine whether the policy covers a trade contractor for a particular claim or suit.¹

1. **“Legally obligated to pay as damages.”** The trade contractor must be “legally obligated” to pay a claim before the payment will be covered by the trade contractor’s liability policy. For example, payments in satisfaction of a court judgment or in settlement of a lawsuit meet this requirement. But insurers sometimes refuse to cover a payment to settle a claim before the claimant has filed a lawsuit.

¹ In addition to covering liability for “bodily injury” and “property damage,” a general liability policy also covers liability resulting from the policyholder’s advertising activities, and from “personal injuries” -- a term that includes harm caused by libel, slander, or product disparagement; false arrest, detention, or imprisonment; malicious prosecution; wrongful eviction from, wrongful entry into, or invasion of the right of private occupancy of an occupied premises; or invasion of privacy. These coverages are generally not applicable to a trade contractor’s construction activities and are not discussed in this paper.

Tip: *Before making a settlement payment to a claimant who has not yet filed a lawsuit, a trade contractor should consult with its attorney to determine whether the payment would be covered.*

2. **“Bodily injury or property damage.”** A liability policy covers only damages that are caused by “bodily injury” or by “property damage.” What constitutes “bodily injury” is usually apparent. If a homeowner, neighbor, or visitor is injured at the jobsite or in the house by the trade contractor’s work, this requirement for coverage is satisfied. What constitutes “property damage” is sometimes less clear. The term is defined to mean “physical injury to tangible property,” or “loss of use of tangible property that is not physically injured.” If damage to the wood substrate results from synthetic stucco, or if a homeowner can’t use the house because faulty electrical wiring presents a safety hazard, the claims against the stucco contractor and electrician would meet the “property damage” requirement. A closer question is presented if the trade contractor’s work suffers physical injury only to itself, e.g. exterior hard board siding warps but does not damage other property. This should meet the definition of “property damage,” but a few courts have held that the damage must be to property other than the trade contractor’s work, even though there is no such requirement in the definition of “property damage.”

3. **“During the policy period.”** The bodily injury or property damage must take place during the period of time that the policy is in effect. It does not matter when the lawsuit is brought. In the case of hidden or undetected bodily injury (e.g. asbestosis) or property damage (e.g. wood rot), it is sometimes difficult to determine

during what period of time the injury or damage was taking place. Nonetheless, the courts in most states require that the actual injury or damage take place during the policy period, even if it was undetected at the time. In the case of progressive injury or property damage, every policy that was in effect while the injury or damage was taking place covers all or at least a pro rata part of the policyholder's damages, depending on applicable state law. The courts in a few states (e.g. Arizona, Maine, Nevada, Rhode Island, Virginia) have a rule that hidden injury or damage "takes place" only when it is eventually discovered. This rule will result in no coverage for the trade contractor if it has gone out of business or otherwise cancelled its policy by the time the hidden injury or damage is discovered. Hence, a trade contractor should consult with an insurance advisor before canceling or not renewing its insurance policy.

Tip: *A trade contractor should consult with its insurance agent, consultant, or lawyer before discontinuing liability insurance, in order to determine whether the trade contractor would be covered for future suits alleging past property damage.*

4. **"Occurrence."** An "occurrence" is defined in most liability policies as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions." For there to be an occurrence, the injury or damage must be fortuitous -- in other words, it must not be expected or intended from the standpoint of the policyholder. The courts are divided as to whether property damage caused by a trade contractor's poor workmanship or defective materials constitutes an occurrence, i.e. an accident. Some courts hold that as long as the trade contractor did not know that its work or materials were defective, any resulting damage is an accident.

Other courts hold that damage caused by defective work or materials can never be accidental because the trade contractor can control the quality of its own work. The “occurrence” issue can be complex and often depends on the particular facts of the claim at issue.

Tip: *Consult with your insurance agent, consultant, or lawyer regarding whether faulty workmanship satisfies the “occurrence” requirement under the law of your state.*

5. Exclusion for property damage prior to completion of

construction. A general liability policy excludes coverage for property damage that takes place while the policyholder is still performing operations. A trade contractor is covered, however, if its workmanship or materials cause property damage that takes place after the trade contractor’s work has been completed. (Work that may later need service or repair but is otherwise complete is still deemed to be completed.) For example, the builder’s suit against the electrician for damage from faulty wiring that causes a fire will be covered only if the damage takes place after the electrician’s work is completed. Property damage that takes place prior to completion of the trade contractor’s operations, although not covered by the trade contractor’s general liability policy, may very well be covered by the builders risk policy.

6. Exclusion for property damage to “your work.” Property damage

to the policyholder’s own workmanship and materials is excluded from coverage, unless “the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor.” This exclusion is not applicable to damage caused by the

trade contractor's work to the work of others, e.g. to work by the builder or by another trade contractor. But there is no coverage for a claim for damage to the trade contractor's own work -- unless the trade contractor used a subcontractor to perform the work. For example, a claim against the stucco contractor based on water damage to the substrate caused by synthetic stucco is not excluded because the damage is not to the stucco contractor's own work, but a claim for defects in or damage to the synthetic stucco itself would be excluded. If the stucco were installed by a subcontractor for the stucco contractor, however, even a claim against the stucco contractor based solely on damage to the stucco itself would not be excluded. Can the stucco contractor argue that the stucco itself was defective and that the stucco manufacturer is a "subcontractor" within the meaning of the "subcontractor exception" to this exclusion? This issue has not yet been resolved by the courts.

7. **Notice.** General liability policies require that the policyholder notify the insurer "as soon as practicable" of (i) an incident that may result in a claim or suit, and (ii) the claim or suit itself. Insurers frequently attempt to deny coverage on grounds of late notice, especially if notice is not given until long after the lawsuit has been filed or even concluded. Fortunately for policyholders, most states require that the insurer prove that it was actually harmed in some real way ("prejudiced") in order to deny coverage based on late notice.

Tip: *Trade contractors should have systems in place to comply with their insurance policies' notice requirements.*

8. **Consent to settle.** General liability policies prohibit the policyholder from settling a claim or lawsuit without the insurance company's consent. This can pose a problem for trade contractors who would like to obtain insurance coverage but who would also like to settle with the homeowner or other claimant prior to suit. If the insurance company denies coverage, the trade contractor is then free to settle with the claimant and afterwards pursue coverage from the insurer. But if the insurer agrees to defend the trade contractor, or if the insurer delays making a decision about whether there is coverage, the trade contractor is not free to settle the claim without the insurer's consent. In that case, the trade contractor should always ask the insurer in advance to consent to any proposed settlement. If the insurer fails to object or does not respond, some courts have held that the policyholder is then free to settle. In addition, some courts have held that, even where a policyholder has settled without asking for the insurer's consent, in order to deny coverage the insurer must prove that it was actually harmed by the settlement, e.g. that the insurer could have defeated the claim or settled it for less.

Tip: *Always ask the insurance company for consent before settling a claim or suit. Consult with an insurance lawyer about the best way to do so.*

9. **Duty to defend.** General liability policies require the insurer not only to indemnify the policyholder for any covered judgments or settlements but also to defend the policyholder -- at the insurer's expense -- against covered lawsuits. This is a significant benefit and is why liability insurance is sometimes referred to as "litigation insurance." In general, the insurer has a duty to defend any suit that even potentially

asserts a covered claim even if it is ultimately determined that the claim is not covered. The insurer has the right not only to conduct the defense of the suit but also to settle the case as it sees fit. The fact that the insurer may agree to defend the suit but reserve the right to deny coverage of any settlement or judgment can cause problems and create conflicts between the insurer and the policyholder -- especially if the policyholder feels that the insurer is not defending the suit vigorously.

Tip: *The prudent trade contractor will consult with its lawyer about its rights and responsibilities regarding the insurer's duty to defend.*

* * *

Tip: *Ask your insurance agent, advisor, or lawyer about what types of claims against you would and would not be covered in light of the terms of your policy and the law applicable in your state. Ask your insurance agent or consultant about the cost of purchasing additional coverage for claims that would not otherwise be covered.*

B. Issues for the Trade Contractor Policyholder

Several coverage issues can arise for trade contractors in particular situations in addition to those discussed above.

1. “Manifestation endorsements.” One or more “endorsements” can be attached to a general liability policy in order to add to or subtract from the coverage granted in the standard form of the policy itself. A policyholder should find out in advance what endorsements the insurer proposes to include in the policy and discuss the effect of such endorsements with its insurance agent, insurance consultant, or insurance lawyer. One such endorsement is the “manifestation endorsement,” which restricts insurance coverage to property damage that is discovered during the policy period,

regardless of when it actually was taking place. Such an endorsement can be particularly harmful to trade contractors who go out of business or otherwise drop their liability insurance after a project is completed. The endorsement deprives the trade contractor of coverage for property damage that takes place while a liability policy was in effect in the past.

Tip: *A trade contractor should ask its insurance agent to make sure that its liability policy does not include a manifestation endorsement. If it does, the trade contractor should be sure to keep its coverage in effect for as long as the trade contractor is subject to suit for property damage that is discovered after completion of the trade contractor's work.*

2. **“Claims made” policies.** As discussed earlier, a standard liability policy covers property damage that takes place during the policy period, even if the claim for such damage is made after the policy expires. Such policies are known as “occurrence” policies. An alternative form of liability policy covers only claims that are made against the policyholder (and reported to the insurance company) within the policy period. These are known as “claims made” policies. Trade contractors should be wary of “claims made” policies. Such policies would not satisfy a requirement in the contract with the builder that the trade contractor obtain “completed operations” coverage. In addition, claims made policies would not cover a claim asserted against the trade contractor after the policy period ended for property damage that took place during the policy period. Hence, a trade contractor who obtained a claims made policy during the period of construction, and then failed to renew that policy, would not be covered for a suit that could be filed months or years after construction was completed. In addition,

even a series of back-to-back claims made policies can pose problems, because the claim or suit must be reported to the insurer during the policy period. The policyholder can easily fail to comply with this requirement, especially as to claims made or suits filed near the end of the policy period.

Tip: *Be wary of “claims made” policies for general liability coverage and be sure to consult with your insurance advisor about the pros and cons of a claims made policy.*

3. “Contractual liability” coverage. One of the most misunderstood aspects of a general liability policy is coverage for “contractual liability.” The builder often requires the trade contractor to have such coverage, believing that it will insure the trade contractor’s contractual obligation to indemnify the builder for liability imposed on the builder as the result of the trade contractor’s faulty work. (This indemnification obligation was discussed at page 6 above.) In fact, contractual liability coverage is something of a misnomer. It covers the trade contractor’s agreement to indemnify others, including the builder, but only for the other’s “tort” liability (which means any liability not based on a contract or warranty) -- not for the other’s liability for breach of contract or breach of warranty. For example, the trade contractor would be covered for the builder’s indemnity claim against the trade contractor based on the homeowner’s claims against the builder for bodily injury, which is a “tort.” But if the builder is sued by a homeowner for breach of warranty and the builder sues the trade contractor for indemnity, the “contractual liability” coverage of the trade contractor’s liability policy would not apply and the trade contractor could be stuck with an uninsured indemnity

obligation. There are other potential paths to insurance coverage for the trade contractor in this situation. The bottom line, unfortunately, is that it is very difficult to predict whether the trade contractor will be insured for the builder's claim for indemnity against the trade contractor.

Tip: *Ask your insurance lawyer about the types of indemnity claims the builder may assert against you that would and would not be covered by your liability insurance policy.*

C. Seeking Help

There are a number of different professionals from whom a trade contractor can obtain advice regarding insurance coverage issues. These professionals can help the trade contractor spend its insurance dollars wisely and can advise the trade contractor regarding the likelihood of insurance coverage in particular situations.

1. Insurance agent. An insurance agent (sometimes called a “broker”) sells insurance products. The agent is usually paid a commission by the insurance company, but the agent is deemed to be the agent of the policyholder for most purposes. One factor in choosing an agent should be the agent's experience with the construction industry. The agent will have a thorough understanding of the insurance market and can help the policyholder choose insurance products that provide the most protection to the trade contractor for the least cost. The agent will also facilitate communications with the insurer's underwriter during the application process and provide information to encourage the underwriter to accept the policyholder's application. (An underwriter determines for the insurer whether the applicant is an acceptable risk.) Finally, the agent

will give notice of a claim to the policyholder's insurer, upon the policyholder's request, and can help the policyholder resolve disputes with the insurer regarding coverage for the claim. Many agents have a claims person or department devoted to helping their clients submit and resolve claims.

2. **Insurance consultant.** An insurance consultant is an independent insurance expert who is not licensed to sell insurance products but who can provide independent advice to the policyholder regarding insurance coverage and claims issues. Such consultants charge a fee to the policyholder for their services. Either separately or together with the policyholder's broker, an insurance consultant can help the policyholder determine its insurance needs, help apply for the insurance policy, make sure the policy to be issued provides the exact coverages requested, help the policyholder present a claim to the insurer, and participate in resolving coverage disputes with the insurer.

3. **Insurance lawyer.** Lawyers who specialize in insurance law can help policyholders understand their rights under insurance policies, present a claim to the insurer in the best possible light, comply with the necessary procedural requirements for presenting the claim, avoid taking actions that will jeopardize the claim, and represent the policyholder in negotiations with or litigation against the insurer to resolve a disputed claim. A good insurance lawyer will know how to work with the insurer, the agent, the policyholder's employees, witnesses, and any necessary experts to negotiate the claim most favorably for the policyholder or bring a lawsuit against the insurer. If your lawyer does not have insurance law experience, ask him to recommend to you a lawyer who

does. Insurance policies can present complex legal issues, and the insurance company will often seek advice from its own lawyers to determine whether the claim is covered and/or to argue why the claim is not covered. One benefit of using a lawyer is that communications with the lawyer and information gathered by the lawyer for purposes of providing legal advice are confidential and cannot be disclosed to the insurance company or used against the policyholder.

D. The Insurance Crisis for Trade Contractors

Trade contractors are not immune from the insurance crisis in the home building industry. Like builders, trade contractors are finding it harder to buy liability insurance, especially for work in certain states (e.g. California) or certain kinds of projects (e.g. townhomes or other attached units). The insurance policies that are available are more restricted, cost more, and contain higher deductibles and lower limits than in the past. The reasons for this change are the same as those that affect builders -- an increase in claims resulting from construction defect lawsuits, losses resulting from September 11, the decline in the value of the insurance industry surplus, and the tightening of the reinsurance market.

This insurance crisis for trade contractors has had several pronounced effects on insurance for trade contractors:

- **Importance of meeting insurers' underwriting criteria.** With insurers becoming more selective in who they are willing to insure, it is increasingly important for trade contractors to be an attractive risk to insurers. One way for trade contractors to do

so is to be “certified” by the NAHB Research Center. The NAHB Research Center certifies trade contractors that have effectively implemented a formal quality system that meets requirements established by the Research Center. The requirements apply to specific building trades and are customized for each contractor. The trade contractor must accept responsibility for its own quality assurance without builder intervention. Quality procedures instituted by the trade contractor tightly control the construction process, require inspection of specific checkpoints, and demand that action be taken to prevent recurring problems. To learn more about the Research Center’s Trade Contractor Certification Program, visit its website at www.nahbrc.org <<http://www.nahbrc.org>>.

The criteria that insurers use to measure the insurability of an applicant include: (i) a history (often five years) of modest or no claims experience (hence, the trade contractor may wish to be selective in choosing which claims to submit to its insurer); (ii) demonstrable quality control and safety programs that are enforced by the trade contractor; (iii) a strong form of contract with the trade contractor’s subcontractors, containing effective dispute resolution procedures to avoid lawsuits, shifting the risk of loss to the subcontractors through warranties and indemnification provisions, requiring the subcontractors to maintain liability insurance, and requiring subcontractors to name the trade contractor as an additional insured on their policies; (iv) a practice of enforcing the foregoing insurance requirements by obtaining certificates of insurance from the trade contractor’s subcontractors; (v) effective jobsite supervision of the trade contractor’s employees and subcontractors; (vi) the absence of high risk activities such as blasting,

excavation, or cranes; no installation of high risk materials, such as asbestos or synthetic stucco (“EIFS”); and no work on attached units; and (vii) no history of cancellation of insurance by another insurer.

Tip: Contact the NAHB Research Center about its Trade Contractor Certification Program.

Tip: Review the factors that will determine whether you are a good insurance risk and spend the necessary time and energy to enhance your compliance with these criteria.

- **“Wrap” and “captive” insurance programs.** The increased cost and lack of availability of liability insurance for trade contractors has led some builders, especially large builders, to use their economic strength to obtain insurance for their trade contractors. In a “wrap” insurance program, the builder buys builders risk and liability insurance for itself and its trade contractors. This can result in lower premiums than if the builder and the trade contractors all bought insurance separately. Alternatively, the builder may create or participate in a “captive” insurance company, which is owned and controlled by the policyholders who supply all its business. A captive insurer can provide coverage that would not otherwise be available, reduce claim expenses, and obtain “reinsurance” against large losses. In either case, the builder will obtain reimbursement from the trade contractors for providing such insurance, either through reductions in the cost of the trade contractors’ bids, which will not include insurance costs, or through a charge to the trade contractors in the nature of an insurance premium. With traditional liability insurance becoming increasingly difficult to obtain, trade contractors are participating more frequently in such alternative forms of insurance.

- **Payment of claims.** It appears that insurers are also responding to the insurance crisis by becoming more stringent in the payment of claims. Nowhere is this more evident than in the home building industry. For example, many claims by homeowners that a trade contractor's insurer might have paid before the homeowner filed a lawsuit must now be handled as a customer service matter, at the contractor's expense, or await the formality of a lawsuit by the homeowner. In addition, insurers are more aggressively asserting and relying on policy exclusions and asserting other policy defenses. In the construction industry, this includes an increased reliance on the argument that property damage resulting from construction defects was not accidental, i.e. was not an "occurrence," and hence is not covered by insurance.

III. THE BUILDER AS AN "ADDITIONAL INSURED" ON THE TRADE CONTRACTOR'S LIABILITY POLICY

The decreased availability and increased cost of general liability insurance for builders has caused builders to seek other forms of risk transfer. One such alternative is for builders to require that they be named as an "additional insured" on their trade contractors' liability policies. This is a common requirement in the contract between builders and trade contractors, and hence it is important for the trade contractor to know how to comply with this requirement, what coverage is afforded to the builder in this way, and what effect insurance claims by the builder as additional insured may have on the trade contractor.

A. Adding the Builder As an Additional Insured on the Trade Contractor's Liability Policy

It is not difficult for a trade contractor to add the builder as an additional insured on the trade contractor's liability policy. In fact, the trade contractor's policy may be written to name automatically as an additional insured any person or organization with whom the trade contractor has agreed in writing to add to its policy. In this case, the trade contractor need only keep a copy of the contract with the builder to demonstrate to the insurer that the builder was required to be named as an additional insured.

In the absence of such an "automatic" provision, the trade contractor simply needs to ask its insurance agent to add the builder as an additional insured on the trade contractor's liability policy. The agent should arrange to do so as a matter of course, and the insurer will usually add the additional insured for no additional fee. To eliminate any doubt, the trade contractor should confirm with its agent when buying the policy that builders can easily be added as additional insureds on the policy for no cost. The trade contractor's agent will issue to the builder, upon request, a "certificate of insurance" stating that the builder has been added as an additional insured on the trade contractor's policy.

B. Coverage Afforded to the Builder As an Additional Insured

The exact coverage afforded to the builder as an additional insured on the trade contractor's policy depends on the particular wording of the trade contractor's policy. There are different forms of additional insured endorsements. Form CG 20 09 provides coverage to the additional insured with respect to liability arising out of the trade

contractor's work for the additional insured at designated locations, or out of the additional insured's general supervision of the trade contractor's work at those locations. Form CG 20 09 goes on to delete certain exclusions from, and to add other exclusions to, the coverage afforded to the additional insured.

Form CG 20 10 is a far simpler endorsement that covers the additional insured "with respect to liability arising out of 'your work' for that insured by or for you." This form of endorsement is generally viewed as providing greater coverage to the additional insured than does CG 20 09, and hence it is preferred by builders.

In 1993, both Form CG 20 09 and Form CG 20 10 were amended to restrict the coverage they provided to the additional insured's liability arising out of the trade contractor's "ongoing operations" for the additional insured. The 1993 versions of these endorsements arguably deprive the additional insured of coverage for completed operations, i.e. for liability for property damage that takes place after the trade contractor's work on the job is finished. The impact on the trade contractor of less coverage for the builder as an additional insured is discussed in the next section.

The insurer also may use a "manuscript" or non-standard additional insured endorsement that provides more or less coverage to the additional insured than is provided by these standard forms. Whatever form is used, the trade contractor should be sure that the coverage provided to the builder as an additional insured on the trade contractor's policy meets any requirements for such coverage in the trade contractor's contract with the builder. If it does not, or if the builder fails to name the builder as an

additional insured at all, the trade contractor can be held liable for any amounts that the builder would have collected from the insurer as an additional insured on the policy. If the contract between the trade contractor and the builder, however, does not specify the type of “additional insured” coverage the trade contractor must provide, then arguably any form of “additional insured” endorsement will satisfy the trade contractor’s obligations under the contract.

Tip: Make sure that the coverage granted to builders as additional insureds on your liability policy meets the requirements in your contract with the builder. If not, you may be required to pay damages to the builder as if you were the builder’s insurer.

Insurance companies and additional insureds frequently disagree over the meaning of the term “arising out of” in the additional insured endorsement. Insurers argue that coverage is restricted to liability that the additional insured incurs solely as the result of the acts or omissions of the trade contractor. Builders argue that the term “arising out of” is far broader and provides coverage for any liability having any relationship to the trade contractor’s presence on the jobsite. The majority of courts side with builders on this issue and interpret the term “arising out of” quite broadly. For example, if a trade contractor’s employee is injured at the jobsite allegedly as the result of the negligence of the builder, the majority of courts hold that the builder is covered for this claim as an additional insured on the trade contractor’s policy, even if there were no allegations that the trade contractor were in any way at fault for the injury. Some insurers are beginning to use manuscript additional insured endorsements to eliminate such coverage for the additional insured’s own acts or omissions.

Another issue is the extent to which the builder's own liability insurance must contribute to the insurance coverage of a builder who is covered as an additional insured on the trade contractor's policy. Depending on the language in the additional insured endorsement, the builder's liability insurer may very well be required to contribute -- thereby defeating one of the builder's objectives in being named as an additional insured on the trade contractor's policy. To avoid this result, the builder will often require that the additional insured endorsement provide that its coverage is "primary and non-contributory." Such language in the endorsement will usually suffice to require that the trade contractor's insurer insure the builder with no participation by the builder's own insurer.

C. The Effect on the Trade Contractor

Although the trade contractor may not be required to pay any fee or additional premium to add a builder as an additional insured on the trade contractor's policy, the trade contractor could be negatively affected in other ways. If the builder makes a claim as an additional insured, the insurer will count the loss against the trade contractor, and hence the trade contractor's claims experience will be detrimentally affected, perhaps requiring the trade contractor to pay a higher premium for next year's policy. In addition, any amounts paid by the insurer to indemnify the builder for a settlement or judgment will count against the total amount of insurance provided by the trade contractor's policy, thereby lowering the remaining limits available to the trade contractor.

On the other hand, the trade contractor derives some benefits from insurance coverage for the builder as an additional insured on the trade contractor's policy. If the builder is being defended and indemnified by the trade contractor's insurer, the builder may have less of an incentive to sue the trade contractor to recoup its losses. Although the builder's own insurer could normally sue the trade contractor who was responsible for the loss to recoup insurance payments made to the builder (this right is known as "subrogation"), the trade contractor's insurer may have waived any right of subrogation against any insured under the trade contractor's policy.

Tip: *Ask your insurance agent to try to obtain a liability policy that contains a waiver of subrogation clause applicable to all the insureds on your policy.*

IV. MANAGING RISK OTHER THAN THROUGH INSURANCE

Just as the builder must bear more and more fortuitous risk without the benefit of insurance, so too must the trade contractor. With insurance premiums buying lower limits and higher deductibles, it is more important than ever for trade contractors to manage such risk through other means. Several methods for avoiding risk, controlling risk, transferring risk to others, and reducing the cost of resolving disputes about who should pay for fortuitous losses are discussed below. In addition to lowering the cost of fortuitous losses, the trade contractor who implements these methods will make itself a more attractive risk and make it easier for its insurance agent to purchase liability insurance for less cost.

A. Risk Avoidance

Risk avoidance means not doing the activity that creates the risk, or at least trying to eliminate that portion of the activity most likely to cause a loss. For example, some builders and trade contractors have decided not to work on multi-family housing projects as the result of the exponentially higher risk that such projects will result in construction defect lawsuits, especially in those states (e.g. California) where construction defect litigation is common. Many builders and trade contractors have decided not to use synthetic stucco or “EIFS” as an exterior cladding because this material has been associated with concealed damage caused by retained moisture behind the EIFS. Some builders and trade contractors, especially foundation and grading contractors, are very cautious about working in geographic regions that contain expansive soils because of the higher number of subsidence or earth movement claims that arise in these regions.

Builders and trade contractors should also remain vigilant when choosing building products and materials and attempt to determine the track record of particular brands. Once selected, if a particular brand appears to be causing more than the normal number of problems, the trade contractor should switch to another manufacturer. In addition, many trade contractors avoid using new building products until they have developed a track record in use and have shown that they are free from hidden defects.

Tip: Take into account the risks involved in the types of projects you work on, where they are located, and the building products you use. Be wary of new building products that have not yet withstood the test of time.

B. Risk Control

Risk control techniques are used to reduce the chance that a particular loss will occur or to reduce the severity of a loss that cannot be prevented entirely. A recognized method of risk control is the implementation of effective quality control and job safety procedures. The additional cost of the training and supervision necessary to implement such procedures is one of the best investments that a trade contractor can make. The cost will likely pale in comparison to the cost of construction defect litigation and worker compensation costs that can result if quality control and job safety is not made a priority.

In addition, a trade contractor should budget for an effective customer service program. The trade contractor should use a well-trained and experienced customer service representative whose function is to solve problems and solve them quickly -- before they escalate into bigger ones. The trade contractor should also have protocols for deploying any responsible subcontractor to address the problem. Once the homeowner hires a lawyer to obtain satisfaction, the cost of solving the problem escalates dramatically. The trade contractor also risks losing the goodwill of its builder clients when it fails to provide effective customer service.

Tip: Make an investment in quality control, job safety, training, supervision, and effective customer service.

C. Risk Allocation

Through contract documents, losses that cannot be avoided or controlled can sometimes be transferred to others, or the trade contractor's loss can be limited. Just as the builder attempts to transfer fortuitous loss to the trade contractor whose work was

responsible for the loss, so too the trade contractor should attempt to transfer the risk of loss to any of its subcontractors who are responsible for the loss. This can be done in the contract between the trade contractor and its subcontractor by requiring the subcontractor to indemnify, defend, and hold the trade contractor harmless from any losses arising out of or associated with the subcontractor's workmanship or materials. The contract should also require the subcontractor to warrant its work against defects in workmanship or materials for specified periods of time, e.g. ten years in the case of structural defects and one or two years for other defects. Finally, the contract should require the subcontractor to purchase specified types and amounts of liability insurance, and to name the trade contractor as an additional insured on its policy.

In the other direction, the trade contractor can attempt to negotiate favorable risk transfer or risk limitation terms with the builder. For example, a trade contractor could attempt to limit its exposure for warranty or indemnification to the value of its contract with the builder. The trade contractor could also negotiate for shorter warranty periods, or disclaim any warranties except those specifically stated in the contract.

Tip: Trade contractors should use a written contract with their subcontractors, and this contract should transfer to the subcontractors losses that arise from the subcontractor's work.

Tip: Trade contractors should review their contract with the builder and attempt to negotiate the risk-shifting provisions in the contract or to limit the trade contractor's liability for losses.

D. Effective Dispute Resolution

Fortuitous losses involve not only the cost of fixing the problem but also the cost of resolving disputes over who is to pay for fixing the problem. Such dispute resolution costs can be expensive -- especially if they are resolved through lawsuits in court. The contract between the trade contractor and the builder, or between the trade contractor and its subcontractor, can provide faster and less costly methods for resolving such disputes. Many such contracts contain binding “arbitration” clauses, which require that disputes regarding performance under the contract be resolved through arbitration rather than through lawsuits. Arbitration is a private proceeding before one or more individuals hired to act as judges of the parties’ dispute. Arbitration is generally simpler, faster, and cheaper than litigation in court and avoids the involvement of a jury. In addition, the parties can agree that before arbitration or litigation is commenced they will attempt to resolve their dispute through mediation, in which a mediator attempts to help the parties reach a settlement of their dispute. Finally, even when the dispute might go to court, the contract can reduce the cost of the lawsuit by waiving the parties’ right to a jury trial, or the contract can reduce the incentive to sue by requiring that each party pay for its own attorneys fees.

The contract might also contain a “notice and right to cure” provision. In the case of a contract between a builder and a trade contractor, such a clause would require the builder to give the trade contractor notice of the alleged defect, an opportunity to inspect the problem, and a certain amount of time -- e.g. 60 days -- for the trade contractor to fix

the problem before the builder could file suit or initiate arbitration against the trade contractor. Such notice and right to cure provisions work most effectively when the builder's contract with the homeowner also contains such a provision, and when the trade contractor is entitled to participate in the notice and right to cure process along with the homeowner and builder.

Tip: Ask your lawyer to review your contracts with builders and with your subcontractors and to recommend cost-effective dispute resolution procedures to include in the contracts.

Conclusion

The dramatic increase in construction defect litigation and the precipitous decrease in the availability of liability insurance requires trade contractors to understand the fortuitous risks of construction activities and to manage them effectively. The trade contractor should know what types of losses are and are not covered by its liability insurance, and the trade contractor should take steps to eliminate, minimize, or transfer to others the risk of losses that will not be covered by insurance.

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For additional information concerning this paper, please feel free to contact the National Association of Home Builders Legal Affairs Department at (800) 368-5242, ext. 8317. You may also contact the author directly at (202) 861-3900 or at stephen.mysliwiec@piperrudnick.com.