



ADVANCED RISK MANAGEMENT FOR HOME BUILDERS

Presented by

Jeffrey D. Masters

**Partner and Cochair, Development Risk Management
Practice Group
Cox, Castle & Nicholson LLP**

Stacy W. McDaniel

**Insurance and Risk Management Specialist
Lockton Insurance Brokers, Inc.**

Frances C. Oliver

**Risk Manager
Centex Corporation**

Home builders face myriad complex and evolving liabilities on residential developments. While many home builders understand the critical role of risk management in their organizations' long-term success, few have taken steps to form a comprehensive and integrated approach to managing these risks. The result is often unanticipated and uninsured liabilities. This session will outline a strategic and integrated approach to managing liabilities in the home building industry.

Thursday, November 16, 9 a.m.–noon

Workshop P



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Jeffrey D. Masters
Partner and Cochair, Development Risk Management
Practice Group
Cox, Castle & Nicholson LLP

Mr. Masters is one of the presenters for Workshop P, “Advanced Risk Management for Home Builders,” on Thursday. He is a partner in the Litigation Department and cochair of the Development Risk Management Practice Group at Cox, Castle & Nicholson LLP, Los Angeles. He represents developers, home builders, and lenders in complex insurance, construction, and business litigation matters. He also has extensive experience structuring insurance and risk management programs for projects of all sizes. Mr. Masters serves as a member of the California Building Industry Association (CBIA) Construction Dispute Resolution Task Force (1995–2000) and CBIA Liability Insurance Task Force (1996–2000). He was a technical consultant on *Broad Form Property Damage Coverage* (3d ed. 1992), published by International Risk Management Institute, Inc., and on *California Liability Insurance Practice: Claims and Litigation* (Cal. Cont. Ed. Bar, 1991). He is a frequent lecturer for real estate industry groups such as Pacific Coast Builders Conference/Western Building Show, National Association of Home Builders, and California Building Industry Association. His commentary and articles on risk management and insurance have appeared in *The Wall Street Journal*, *Los Angeles Business Journal*, *Professional Builder*, *The Risk Report* (IRMI), and *Contractual Risk Transfer* (IRMI). He is a graduate of UCLA School of Law and UCLA Anderson Graduate School of Management.

Stacy W. McDaniel
Insurance and Risk Management Specialist
Lockton Insurance Brokers, Inc.

Ms. McDaniel is one of the presenters for Workshop P, “Advanced Risk Management for Home Builders,” on Thursday. She is currently employed by Lockton Insurance Brokers, Inc., in Irvine, California, as a specialist in risk management and claims handling. Her primary clients are in the construction industry, with a particular emphasis in providing service to home building clients. Ms. McDaniel recently joined Lockton after spending the past 11 years in the home building industry, performing dual roles as in-house corporate counsel and risk manager to two nationally recognized home builders, the most recent of which was Lennar Corporation. Prior to her experience in the home building industry, Ms. McDaniel practiced law for more than 5 years with private law firms, where her clients included developers and home builders, lenders, and mortgage insurers. In addition to her legal and risk management expertise, Ms. McDaniel holds a California real estate brokers license, and has lectured frequently for legal and construction industry gatherings. Ms. McDaniel has also served on the Board of Directors for the American Corporate Counsel Association, Southern California Chapter.

Frances C. Oliver
Risk Manager
Centex Corporation

Ms. Oliver is one of the presenters for Workshop P, "Advanced Risk Management for Home Builders," on Thursday. As risk manager, Ms. Oliver is responsible for risk management and financing activities at Centex Corporation, a Fortune 500 publicly traded company located in Dallas that specializes in residential and commercial building, pest control and lawn care, security alarm installation and monitoring, long-term care facilities, manufactured housing, real estate development, and mortgage banking; and Centex Construction Products, Inc., a separate publicly traded entity consisting of cement plants, wallboard plants, and readymix/aggregate operations. She oversees insurance purchasing and risk financing for both organizations. Interfacing with subsidiary companies is one of her primary functions. She is involved in the management of Centex's Vermont captive. Prior to joining Centex in 1992, Ms. Oliver worked at various insurance agencies and brokers. She is currently a member of the RIMS External Affairs Team and cochairs the Certificates of Insurance Task Force for RIMS, serves on Zurich's Risk Management Advisory Board and FM Global Risk Management Executive Committee, and was formerly chair of the RIMS Research Committee. She was also vice president, secretary, and assistant secretary for DFW RIMS Chapter, and a former member of the Texas State Office of Risk Management Board of Directors. She earned a business degree from Northwestern State University in Louisiana.

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I. Overview of Liability Issues for Homebuilders

- A. Legal Liability
 - 1. Negligence
 - 2. Warranty
 - 3. Strict Liability
 - 4. Fraud
 - 5. Breach of Fiduciary Duty
- B. New Major Claims/Exposures
 - 1. Construction Defects
 - a. Design
 - b. Workmanship
 - c. Code Violations
 - 2. Soils
 - 3. Mold
 - 4. Fraud (Nondisclosure and misrepresentation)

- 5. Homeowners' Association Governance Issues (*e. g.*, budgets)
- 6. Job Site Injuries
- 7. Others

II. Key Risk Management Strategies

- A. Entity Structure
 - 1. Entity Selection
 - a. Partnership
 - b. Corporation
 - c. LLC
 - d. Use of Project-Specific Entities
 - 2. Avoiding Attacks on the Entity
 - a. Alter Ego
 - b. Enterprise Liability
 - c. Parent-Subsidiary Relations
 - d. Substantive Consolidation

- 3. Observing Formalities
 - a. Partnerships
 - b. Corporations and LLCs
 - 4. Dissolution and Wind-up
 - a. Post-dissolution liability of the entity
 - b. Post-dissolution liability of the partners, shareholders, and members
 - c. Do you *really* want to dissolve the entity?!
- B. Land Acquisition
- 1. Site selection
 - a. Onsite Conditions
 - (1) Location
 - (a) Soil conditions
 - (b) Wind exposure
 - (c) Environmental Concerns
 - (i) Hazardous Materials
 - (ii) Biological Concerns
 - (2) Infrastructure Availability/ Capacity
 - (a) Water
 - (b) Schools
 - (c) Traffic
 - b. Offsite Conditions
 - (1) Airport(s)
 - (2) Open space; future use
 - (3) Environmental issues
- (4) Rear yard fences and structures
- (5) Electrical Transmission lines
- C. The Purchase Agreement
- 1. Seller Entity (net worth?)
 - 2. Seller Reps and Warranties
 - 3. Post-Closing Obligations (and how to secure them)
 - 4. Seller Financing (partial releases)
 - 5. Buyer's Remedies
 - 6. Release of Seller vs. Indemnification
 - 7. Profit/Price Participation
- D. Marketing
- 1. Price to the Market (or if you build it, they may not come)
 - 2. Infill vs. emerging markets
 - 3. Demographics
- E. Entitlement Review
- 1. Why It Is Important?
 - 2. How to Approach and Document
- F. Pre-Construction
- 1. Review of Plans
 - a. Offsite Plans
 - (1) Drainage
 - (2) Annexation issues
 - (a) Order of Phases
 - (3) Common Area Landscaping
 - (a) Account for growth of vegetation
 - (b) Account for setback requirements at maturity

b. Onsite Plans

- (1) What foundation system assumptions exist?
- (2) Coordination among design team members
- (3) Peer Review
 - (a) Second opinion as to design standard of care
- (4) The internal design team
 - (a) Have plans reviewed for “value engineering”
 - (b) Avoid past mistakes
 - (i) Solarium Windows
 - (ii) Flat Roofs
 - (iii) Zero overhang roofs
 - (iv) Zero overhang roofs
 - (v) Balconies/second level decks
 - (vi) Potshelves
 - (vii) Parapet roofs
 - (viii) Use of 10 minute building paper
 - (ix) Use of 1 step stucco process in exposed areas
 - (x) Deficient sound attenuation elements
 - (c) Institute a tracking mechanism to identify common assembly issues and avoid them in future design
 - (d) Incorporate lessons learned from field inspections

G. Contract Administration

1. Indemnity Provisions

- a. Permissible Scope (watch state law restrictions)
- b. Don't modify broad form indemnity without considering implications
- c. Minimize risks of inconsistent provisions in various construction documents
- d. Spell out duration and survival of provision
- e. Consider specific provision that attorneys' fees spent pursuing indemnity rights are also recoverable
- f. Indemnity needs to be backed with contractual liability insurance coverage
- g. Need periodic review and update to reflect frequent legal developments

2. Insurance Requirements

- a. Need for comprehensive requirements and compliance by contractors, subcontractors, design professionals, consultants, and others
- b. Importance of periodic review and update of requirements

3. The need for effective contract administration is increased by use of “subcontractor warranty” endorsements to builders' GL policies

- a. Typical Subcontractors' Warranty Endorsement Wording
- b. Try to modify wording
- c. Consequences of non-compliance with endorsement

- H. Construction Quality Assurance
 - 1. Peer review of design drawings and calculations
 - 2. Field inspections (documented and photographed)
 - 3. HOA Common Area Maintenance Manuals

- I. Legal Documentation
 - 1. Contractor and subcontractor agreements
 - 2. Design professional contracts
 - 3. Consultant contracts
 - 4. Consumer sales agreements
 - 5. Homeowner manuals and warranties
 - 6. CC&Rs and other homeowners association governing documents
 - 7. Homeowners association turnover documentation

- J. Customer Service
 - 1. Effective Post-Sale Customer Service
 - a. Advantages of Effective Post-Sale Customer Service
 - (1) Reduced cost
 - (2) Reduced litigation
 - (3) Increased customer satisfaction
 - (4) Repeat customers
 - (5) Referrals of other homebuyers

- b. Strategies for Success
 - (1) The customer service documents
 - (a) The warranty
 - (b) Homeowners' Manuals
 - (c) Objective Construction Standards
 - (d) Disclosure Documents
 - (2) The customer service program
 - (a) The partnership between construction and customer service
 - (b) Trained customer service representatives
 - (c) Pre-closing customer service
 - (d) Post-closing customer service
 - (e) A 10-year relationship
 - (f) Maintenance guidelines
 - (g) Speed of care
 - (h) Quality of care

- K. Claims Handling
 - 1. Early retention of consultants/experts (build your defense team)
 - 2. Use of attorney-client and attorney work product protections
 - 3. Provide timely notice to potentially involved parties and their carriers (especially where builder is an additional insured)

4. Notify builder's insurers
 5. Watch "voluntary payments" and "cooperation clause" issues
 6. Use of tolling agreements
 7. Trend toward early mediated resolution of disputes?
 - a. California's *Calderon* Act and Nevada's NRS 40.600 procedures
 - b. Strategies for diverting claims from traditional litigation and using ADR
 8. Role of builder's defense counsel and coverage counsel
 9. Role of builder's risk manager and insurance broker
- L. Merger/Acquisition Due Diligence
1. Understand the nature of the transaction
 2. Understand present and past operations
 - a. Land Operations
 - b. Contractor and supplier relationships
 - c. Construction practices
 - d. Sales practices
 - e. Warranty practices
 - f. Safety practices
 3. Human resource issues
 4. Insurance coverage review
 5. Exposure Data
 6. Loss Data
 7. Transitional Issues

III. New Insurance Challenges; New Insurance Products

- A. Why Insurance Planning and Execution is So Critical to Builders
1. Builders need tail coverage
 - a. Mismatch between policy term (usually one year) and statute of repose (10 years in CA)
 2. Claims taint builder's loss history
 - a. Makes go-forward insurance difficult to obtain and more expensive
 - b. Creates *Montrose* exclusion problems
 - c. Problem in company acquisitions - Oldco exposures become Newco losses
 3. Subcontractor Coverage
 - a. Difficult to obtain
 - b. Difficult to provide proper additional insured status to builder
 - c. Impossible to verify adequate coverage without individual policy review
 4. Contract administration burdens for builders
 - a. Certificates of insurance
 - b. Additional insured endorsements
 - c. Tracking renewals
 - d. Non-Standard Policy Forms
 - e. "Hidden" Exclusions
 - f. Continuity of Trade Contractor Entities

5. Construction defect claim nightmares
 - a. Multiple attorneys and experts
 - b. Finger pointing proves plaintiff's case
 - c. Huge transactional costs
- B. The Need for Strong Broker Relationships
 1. Depth of Specific Market Experience
 2. Ability to Innovate
 3. Marketplace Challenges
 4. Claims Expertise
- C. Current Challenges in the Liability Insurance Marketplace
 1. Defect claims make builders unattractive to insurers
 2. High premiums
 3. Non-admitted insurers
 4. Fewer long-term relationships with insurers
 5. Non-standard policy forms
 6. "Hidden" exclusions
 - a. The residential work exclusion
 - b. The Condominium, Apartment, Attached Work Exclusion
 - c. "Montrose" Endorsements
 - (1) "Known" Loss Exclusions
 - (2) "Continuing" Loss Exclusions
 - (3) The New Proposed ISO Language
 7. "Burning" limits

8. "Modified occurrence" policies
9. Additional Insured endorsements
10. "Other insurance" clauses
11. The battle over "primary and noncontributing"

IV. Different Insurance Options Available: New Structures and Strategies

- A. Conventional GL Coverage
 1. Standard term policies
 2. Standard term policies with PCO Extension
- B. Project Specific Policies
 1. Covers construction in progress plus tail
 2. Use for single projects or groups of projects
- C. Discontinued Operations or Tail Policies
 1. Provides tail coverage for completed project(s)
 2. Puts past projects into separate insurance "bucket"
 3. Can be written on a "project specific" basis
- D. Owner Controlled Insurance Programs (wrap-ups):
 1. Builder obtains coverage for itself and subs (sometimes design professionals)
 - a. general liability
 - b. workers comp
 - c. builder's risk
 - d. professional liability

2. Subs bid without insurance costs or builder takes insurance credits
3. Can insure single project, group of projects or all projects

E. Wrap Up Options:

1. GL only
2. GL/Worker Compensation
3. “Rolling” Wrap Ups
4. Integrated GL/Warranty Policies
 - a. “Seamless” integrated GL & warranty product
 - b. Coverage for “defects” without “property damage”
 - c. Builder sets performance standards
 - d. Builder performs warranty service
 - e. Builder can credit warranty costs against its SIR
 - f. Fully insured warranty program

V. Insurance Market Report

A. Renewal Strategies

1. Current conditions
2. Predictions and trends: Is a harder market coming?

B. What Should Builders Do To Prepare Themselves?

1. Look for multi-year deals
2. Make your company more attractive to underwriters
3. Build relationships
4. Improve QC programs and contractual protections

VI. Impacts of Growth in the Homebuilding Industry on Inland Marine Risks

A. Aggregation of Risk

1. Master-Planned Communities

- a. Development Patterns
 - (1) Smaller lots
 - (2) Homes closer together
 - (3) Larger building phases
- b. Outlying Areas
 - (1) Volunteer fire departments
 - (2) Well water
 - (3) Extreme heat
 - (4) Poor soils/topography

2. Infill Communities

- a. Environmental Concerns
 - (1) Former Industrial Uses
 - (2) Former Military Uses
 - (3) Changing Environmental Standards
- b. Crime Concerns
 - (1) Theft
 - (2) Vandalism
 - (3) Arson

c. Proximity to Other Structures

- (1) Fire
- (2) Encroachment
- (3) Flooding/Drainage

3. Consolidations in the Building Industry

B. Better Technologies/Better Practices

1. Seismic Standards
2. Fire Suppression
3. Soils Technology
4. New Products
5. Safety
6. Improved Quality Focus

C. Increased Business Interruption Exposures

1. Publicly-held builders
2. Turnkey operations
3. Shortages of labor and materials
4. Processing delays

D. Current Trends

1. New Entities
2. Self Insurance
3. New Markets

VII. Conclusions

1. Builders must commit resources.
2. Policy forms need special attention.
3. Trained, sophisticated risk management professionals are needed now, more than ever.
4. Is the window of opportunity closing?
5. There are bright spots on the horizon.

ADVANCED RISK MANAGEMENT FOR HOME BUILDERS

NON-INSURANCE RISK MANAGEMENT STRATEGIES

by Jeffrey D. Masters
Cox, Castle & Nicholson, LLP, Los Angeles

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 - D. Notify Other Parties
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 - F. Tolling Agreements
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- A. What Is The Builder's Exit Strategy
 - B. Releases
 - C. Other Settlement Issues

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I. Importance of Non-Insurance Risk Management Strategies For Builders

A. What Is Risk Management

“Risk management is the process of identifying and analyzing risk, determining the most appropriate techniques for handling those risks, implementing the techniques, and monitoring the results. It differs from the old approach to managing these risks, frequently called insurance management, in that it recognizes that there are alternative techniques for handling these risks, that insurance is frequently the most expensive of all the available techniques, and that insurance should be used only as a last resort.”¹

B. Why is Non-Insurance Risk Management Critical For Builders

1. Insurance is expensive to procure, maintain and manage.
 - Direct cost of premiums.
 - Indirect cost of management time and effort.

¹*Construction Risk Management* (International Risk Management Institute, Inc. [“IRMI”], 1984 and 1995 Supp.), p. I.A.1. For further discussion, see “Risk Management For Builders: It’s More Than Buying Insurance”, *Builder’s Management Journal* (March/April, 1996).

2. Many key liability exposures may not be covered by standard builder policies or may be only partially covered. *Examples:*

- Pollution claims.
- Intentional torts.
- Fraud and non-disclosure claims.
- Pure economic loss or contractual claims which do not involve bodily injury, property damage, advertising injury or personal injury.

3. Avoiding, minimizing or shifting liabilities results in better loss history. Fewer losses means lower premiums.

4. CAUTION: Watch for non-standard insurance policy forms.

- There is some standardization of basic insurance policy forms and certain endorsements (i.e., ISO forms). But even ISO has various versions of its “standard” general liability policy form available for use.
- Liability insurers (especially non-admitted insurers) increasingly use their own modified forms. These may look like ISO forms, but can have significant differences. Always read the specific policy form and endorsements in question.

- C. Builders Should Pursue A Four-Part Risk Management Strategy: Avoid, Minimize, Shift, Or Insure Liabilities

II. Overview of Liability Risk Management Measures.

A. Four Liability Risk Management Objectives

To *avoid, minimize, shift* or *insure* liabilities.²

B. Avoid Liabilities

Liabilities can be *avoided* in the first instance by such tactics as prudent site evaluation, effective design and construction practices, and careful project supervision.

C. Minimize Liabilities

Liabilities can be *minimized* by such tactics as protective provisions in CC&Rs and consumer sales contracts, disclosures, effective sales training, aggressive customer service, prompt settlements (*e.g.*, performing corrective work or early payment of money in return for a release), or even by offers to rescind the sale.

D. Shift Liabilities

Liabilities can be *shifted* by provisions in contracts with other parties to the construction process, including design professionals, contractors, subcontractors, and suppliers. *Examples:* well-defined scope of work, code compliance and performance standards; indemnification and insurance requirements.

E. Insure Liabilities

Finally, certain liabilities can be *insured*, although this is the most expensive solution and often does not have a high degree of predictability because of different insurers' claims handling practices and disputes regarding the extent of coverage.

III. Site Conditions and The Construction Process

A. Site Evaluation

Careful pre-acquisition due diligence can reveal significant future disclosure and construction issues. Additional relevant information will be acquired during the construction process. *Examples:*

1. Geotechnical—expansive, collapsible, sulfates, corrosive soil; seismic faults.
2. Noise (aircraft, traffic, other sources).
3. Proximity of future construction (inside and outside the project) and uses of adjacent parcels.

B. Scrutiny During Construction

Potential future trouble areas should be identified for increased scrutiny during construction, possible special disclosures, and the like. *Examples:*

1. Soils.
2. Site drainage and grading.
3. Offsite improvements, including curbs, gutters and streets.
4. Slabs and foundations.
5. Major trades, including framing, waterproofing (above grade and subterranean), roofing, electrical, plumbing, HVAC, stucco, windows and doors, landscape, hardscape, site retaining walls and boundary walls.
6. Acoustic.
7. Life/safety, including fire resistive construction and unit ingress and egress.
8. Indoor air quality.
9. Common area amenities.

²For a more detailed discussion of this four-part strategy, see "Reducing Construction Defect Liability Risks in REO Operations", *Real Estate Finance* (Winter, 1993).

C. Constructability Analysis

Review plans and drawings for constructability. Use a peer review program to identify and correct potential future trouble areas during design and construction. This is especially useful for framing, roofs and other major components identified above.

D. Forensic Inspection and Documentation Program

1. Photo logs of correct as-built conditions.
2. Certification by structural engineer and other design professionals of compliance with plans, specifications, codes, and the like.
3. Collect inspection results into a project documentation book and save indefinitely.

E. Management of Project Staff

Critical need for care in selecting, retaining and managing project professional staff and construction superintendents. Poor supervision and turnover of project staff are frequent sources of trouble.

IV. Engaging and Managing Contractors and Subcontractors

A. Quality Control

The current liability environment demands increased attention to selection of contractors and subcontractors, and enforcement of quality control programs.

1. *Examples:* bondability of contractors and subcontractors, track record re warranty work, ability to maintain insurance coverage, claims history.
2. Pre-qualifying contractors and subcontractors is increasingly important due to the number of contractors and subcontractors which left the business and were replaced by new and untested entities.

B. Important Contract Provisions

1. Correct scope of work, tailored for the specific project and product type. (Boilerplate may be inadequate).
2. Performance standards. Representations regarding expertise, knowledge of site conditions, applicability of and compliance with codes, and the like.
3. Warranties.
4. Indemnification.
 - In today's market, be prepared for resistance to broad Type I indemnity. How should builders respond?
 - Reverse indemnity?
5. Insurance, including products/completed operations.
 - Insurance must be maintained after completion.
 - Certificates of insurance.
 - Additional insured endorsements.
6. Bonding requirements.
7. Termination grounds and procedures. (Major source of claims.)
8. Alternative dispute resolution ("ADR") provisions and waiver of jury trial.

C. Contractor and Subcontractor Performance of Customer Service and Warranty Work

1. Consider post-completion retention to assure completion of warranty work.
2. Track performance over time. Build an approved list of contractors and subcontractors.

V. Engaging and Managing Design Professionals and Engineers

A. Similar Issues as With Contractors and Subcontractors

1. Correct scope of work.
2. Performance standards. Representations regarding expertise, knowledge of site conditions, applicability of and compliance with codes, and the like.
3. Warranties.
4. Indemnification.
 - In today's market, be prepared for resistance to broad Type I indemnity. How should builders respond?
 - Reverse indemnity? May not be covered as "insured contract" under builder's liability policy.

B. Limitations of Liability

1. Validity upheld in several states. *See, e.g., Markborough California, Inc. v. Superior Court*, 227 Cal.App.3d 705 (1991) (clause held to be valid under Civil Code § 2782.5, where the parties had a fair opportunity to accept, reject or modify the provision and there was no evidence that the developer lacked such opportunity or that the provision was invalid due to inconspicuousness).
2. Dangerous for builder who does not think through the implications.
3. If limitation of liability cannot be deleted, consider limiting it to certain types of claims, limiting it to amounts not paid by insurers, or tying it to the amount of the unimpaired limits of the party's insurance coverage.

C. Insurance

1. General liability coverage.

2. Professional liability (errors & omissions coverage). What are the limits of coverage provided—it can be impaired or exhausted on other projects. Is the coverage in any way restricted?
3. Consider use of owner-controlled insurance program ("OCIP") or "wrap-up", which can be structured to insure the major parties to the construction process under a single insurance program.

VI. Construction Contract Administration Issues

A. Indemnification From Design Professionals, Contractors, Subcontractors, and Others

1. Drafting considerations.
 - If the other party seeks to modify the builder's indemnity provision, think through the implications before you consider the request. Don't rubber stamp modifications.
 - Periodically revise and update contract language. (Boilerplate may be inadequate.)
 - What is the permissible scope of indemnification? Some states have "anti-indemnification" statutes. *See also* California Civil Code § 2782 (party to construction contract cannot be indemnified as to its sole negligence or willful misconduct).
 - Use of savings clause (*i.e.*, indemnification "to the fullest extent permitted by law").
 - Assure that indemnification provisions in different parties' contracts are consistent and that there is consistency in each tier.
 - Spell out the duration and survival of the indemnity provision.
 - Specific agreement that attorneys' fees incurred in pursuing indemnity are also recoverable.

2. Enforcing the subcontractor’s indemnity obligation.

- Critical importance of proper drafting to maximize builder’s enforcement rights.
- In some states, builders can shift liability risks (even strict liability) to non-negligent subcontractors. *See Continental Heller Corporation v. Amtech Mechanical Services, Inc.*, 53 Cal.App.4th 500 (1997) (general contractor entitled to indemnity from subcontractor for damage “arising out of” subcontractor’s work even though subcontractor not at fault; general contractor also awarded attorney’s fees incurred in pursuing indemnity rights).

3. Does the other party’s liability insurance provide coverage for the contractual indemnification obligation?

- Most liability policies typically include contractual liability coverage automatically, if the indemnity agreement qualifies as an “insured contract” as defined by the policy.
- However, coverage for the indemnification obligation generally is provided only for “bodily injury” or “property damage”, as defined by the liability policy.
- As a result, there may be no coverage for damages not resulting from “bodily injury” or “property damage”. *Example:* strictly economic losses where there has been no “property damage”.

B. Insurance Requirements In Construction Contracts

1. Limits

How much is adequate? How much can the builder expect to actually get in today’s market?

2. Duration

How long should the coverage be required to remain in effect? Ideally, the coverage should be maintained in effect so long as the builder (the party imposing the insurance requirement) can be sued. Although construction documents may require the insurance coverage to remain in effect for a specified time after completion or termination, this is difficult to enforce.

- One approach is use of an “approved contractor” list, made up of contractors and others with a track record and financial stability which suggest that they will be likely to maintain their insurance in effect for the long term.
- Ultimately, the builder wants its own insurance program to be the *last* line of defense.

3. Subcontractor Broad Form Coverage

Subcontractors must carry broad form property damage coverage to maximize protection for the builder. *See INA v. NAICC*, 37 Cal.App.4th 195 (1995) (roofing subcontractor’s insurer obligated to pay \$1.5 million in roof damages, even though not caused by roofer’s sole negligence; broad form coverage extended to developer whose Type I contractual indemnity provision caused roofing subcontractor to be “derivatively liable”; such derivative liability not excluded).

4. Obtaining Certificates

Insist on obtaining certificates of insurance before any work commences. *Rationale:* failure to strictly enforce contractual insurance requirements might be construed as a waiver of, or estoppel to assert, the requirements. In addition, the builder needs adequate time to evaluate the certificates and endorsements to address possible deficiencies.

5. Managing certificates of insurance

- Various forms of certificates are in use. Each must be carefully evaluated.
- There are significant limitations inherent in certificates of insurance. In some cases, the builder will want to obtain a copy of the policy and the endorsements.

6. Managing additional insured endorsements

- The builder must be certain it has obtained additional insured status under the other parties' policies, as required by the construction documents. However, a certificate of insurance by itself may not adequately evidence additional insured status.
- The actual additional insured endorsement should be reviewed. Builders should be aware of different rights afforded by different endorsement forms. *Example:* endorsement forms CG 20 09 11 85 and CG 20 10 11 85, which are widely used in the construction industry.

(1) CG 20 09 11 85 contains an "additional exclusion" for certain completed operations. As a result, it may be of little use in a post-completion construction defect claim.

(2) CG 20 10 11 85 does not contain a completed operations exclusion, so it (or an equivalent) is preferable in the context of construction operations.

Caution: newer forms of the 20 10 endorsement may *exclude* completed operations. Careful review of the actual endorsement is required prior to acceptance.

- Beware non-standard additional insured endorsement forms, which may or may not cover completed operations and which may exclude certain types of work by the subcontractor.

7. Compliance with conditions in builder's policy re: subcontractor liability coverage

- Many builders' policies require the builder to obtain or "endeavor to" obtain certificates evidencing specified amounts of subcontractor coverage; indemnity agreements from subcontractors; and additional insured status on subcontractors' liability policies.
- Effect of failure to comply with one or more of the conditions.

VII. Homeowners Association Formation, Operation and Turnover

A. Adequacy of Budget

1. Typically, lack of maintenance by the homeowners association ("HOA") is asserted as a defense in construction defect cases or provides the basis for a comparative negligence argument.
2. The likely response by the HOA is that the budget was inadequate to perform the maintenance and that the builder did not provide guidelines as to required maintenance.
3. Accordingly, preparation of the HOA budget requires special attention. First, manuals or guidelines provided by state real estate regulators may be a minimum only, not an absolute safe harbor. (This applies to two elements: the recommended reserve numbers, and the anticipated useful life/maintenance cycle of project components.) Second, the builder will need to review the project components as they actually are designed and built, then anticipate real maintenance.

nance costs over time. Input can be obtained from vendors, contractors, subcontractors, and design professionals, both on the adequacy of budget items and on guidelines for required maintenance.

4. When preparing budgets, builders typically strive to keep costs low because of the perceived effect of high assessments on marketing and sales efforts. Builders must be careful not to allow such concerns to leave the association underfunded.
5. A critical component of every association budget is reserves for capital improvement maintenance, repair and replacement. For example, California Civil Code § 1365.5 requires the board to conduct a reserve study at least once every three years. Thus, it is likely that the builder's calculations will be reviewed by the association soon after the builder completes the project. Evidence that the builder's reserve calculations were inadequate may render the builder vulnerable to attack.

B. Presence At The Project

Maintenance of a visible presence on the board after turnover is recommended, possibly by an advisory member representing the builder. The builder's representative can serve as a liaison with the homeowners, helping to maintain a positive relationship and diffuse tension before it grows into a claim.

C. Turnover Procedures

Use of detailed turnover procedures is suggested.

1. Conduct a detailed review of project conditions and maintenance at time of turnover.
 - Opportunity to take photos, videos, detailed job walk notes, and the like. Document the builder's record.

- Opportunity for more education of homeowners and HOA.

2. Obtain HOA signoff to the as-built condition of the project. Obtain representation that HOA has inspected the project to the fullest extent it feels necessary. Indicate that the builder is relying on such signoff.
3. Use turnover as an opportunity for further disclosure, if needed.
4. Obtain prompt release of bonds (common area improvements, maintenance assessment) by HOA. This recurring problem grows worse the longer the builder leaves the bonds in place because it becomes more likely that the HOA will find "defects" in the common area that delay or preclude release of the bonds. There is no easy solution except to carefully monitor the status and completion of the bonded work and move aggressively to obtain bond release. Different jurisdictions handle bond release in different ways. Frequently, the HOA will leverage the bond release to attempt to extract concessions from the builder.

VIII. Protective Provisions In CC&Rs and Related Project Documents

A. Builder Rights and HOA Responsibilities

1. Consider imposition of mandatory inspection and maintenance obligations on the part of the HOA.
2. Provide builder with rights for site access, inspections, invasive testing, corrections (*e.g.*, to satisfy local agency to obtain bond release).
3. Limit the incentive and the ability of the HOA to sue the builder.
4. Provide for alternative dispute resolution (*e.g.*, mediation, judicial reference or arbitration) for claims against the builder.

5. Creation and disclosure of project expansion/contraction/reconfiguration rights. Effect on values, assessments, amenities, etc.
6. Require the association to provide each owner with detailed notice of any potential action against the builder (or any other party) prior to commencement of litigation. The purpose of such requirement is to prohibit the board from operating in a vacuum and provide members with adequate information about any association-initiated litigation.

B. Legal Changes Give Builders More Flexibility

For example, changes to California Gov't Code § 66427 provide builders with greater flexibility in structuring condominium projects. Builders now can create three-dimensional airspace parcels, increasing their ability to redesign the project. These changes also allow the builder to convey fee title to certain common area improvements to the association, as opposed to conveying a fractional interest in such common areas to each purchaser. This minimizes the risk that all project owners will be held personally liable for injuries or claims arising in connection with the common areas.

C. The Calderon Act

California's Calderon Act, Civil Code § 1375, effective January 1, 1996, requires notice and an opportunity to meet and confer before the association for a development or project with 20 or more units may sue the builder.

D. Nevada Revised Statutes § 40.600 et seq

NRS §§ 40.600 through 40.695, inclusive, which apply to claims or causes of action which arise after July 1, 1995, require written notice to the contractor of defects, damages and injuries, offers an opportunity for an inspection by the contractor, and provides protocols for written offers of settlement by the contractor to the claimant. The statute al-

so requires that the matter be submitted to mediation before a complaint may be filed in court, unless mediation is waived in writing by the contractor and the claimant.

IX. Protective Provisions In Consumer Sales Documents

A. Possible Approaches and Ideas

1. Similar approaches as with CC&R provisions.
2. Omit attorneys' fees provision.
3. Consider mandatory ADR and jury trial waiver. Judicial reference, arbitration, mediation.
4. Provide builder with rights for site access, inspections, invasive testing, corrections.
5. Specify homeowner obligations regarding inspections and maintenance of the residence.
 - a. Type and scope of obligations.
 - b. Educate homeowners via homeowner manual, maintenance guidelines, warnings regarding alterations and additions, special addenda to purchase documents, and the like. Receipt for each of these items prior to the close.
6. Notice and opportunity to cure required before suit.
7. Repurchase option.
8. Anti-fraud provisions.
 - Integration clause and disclaimer of representations, supported by separately initialled addenda.
 - Specifically tailored "as is" provisions.

9. Limitation on buyer remedies in the event buyer discovers (or seller discloses) an adverse material fact prior to closing. *See Jue v. Smiser*, 23 Cal.App.4th 312 (1994).

Examples: Limit remedy to termination of escrow, with return of deposit to buyer; notice to seller and opportunity to cure; or buyer waiver of right to sue if buyer elects to proceed.

10. Express warranty plus disclaimer of any other warranties.
11. Walkthrough procedures and punch list. Agreement as to completion of items.

B. Disclosures

1. Disclosures are a powerful but underutilized liability prevention tool. Particular attention is recommended as to adequacy of disclosures, including such issues as:
 - Seismic.
 - Soils.
 - Noise.
 - Views.
 - Environmental/toxics.
 - Assessments, fees and charge (assessment districts, homeowner association assessments, and the like).
 - Boundaries and physical features (i.e., proximity of common area, proximity of third party property, slopes, berms, monuments, and other sources of disputes).
 - Future construction (inside and outside the project).
 - Project expansion, contraction, and reconfiguration rights. Effect on values, assessments, amenities.
 - Changes in pricing, sales concessions, and the like.

2. Training and management of salespeople.
3. Preparation and review of marketing materials and public reports with the objective of minimizing actionable representations or omissions.
4. Other possible sources of actionable representations: model units, plans and specifications, topo maps and tables, and the like.

X. Customer Service and Warranty Work

A. Importance of Records

Performance of repairs can toll statutes of limitations. As a result, the builder needs a record of the start and completion dates so that the tolling period is clearly defined.

B. Training

Need for improved training for customer service staff. Importance of written records and document retention.

C. Claim Procedures

Need for simple claims procedure that homeowners can understand.

D. Budgets and Reserves

Need to set appropriate customer service and warranty budgets and reserves.

1. Role of insurance (builder's and other parties').
2. Need for analysis of prior customer service expense history, prior claims (recurring claims and patterns), solvency and claims history of contractors, subcontractors, partners, others.

E. Need For Consistent Customer Service and Warranty Approach

1. Use care to avoid setting unwanted precedents.
2. Builder must be aware that there is little or no confidentiality with regard to customer service and warranty work.

F. How Long Must Customer Service Work Be Performed

1. Expiration of the express warranty does not necessarily terminate the need for customer service work.
2. Only practical outside limitation is when all statutes of limitations have run and the builder can no longer be sued for the item in question.

G. Settlement Documents

Preparation of appropriate releases and other settlement documents. Use of “plain language” short form settlement agreements with individual homeowners.

H. Other Benefits of Good Customer Service

A strong customer service program can have significant benefits beyond claims minimization.

Example: Builders that plan to continue development in the area will find that strong customer service can be a marketing plus. Conversely, homeowner complaints can attract unwelcome attention from local officials.

Example: Customer service records can tell the builder which trades and design details are consistent sources of problems.

XI. Post-Completion Issues

A. Record Retention

1. Builder record retention policies.³
 - a. What records should be kept?
 - b. How long should they be kept?
2. Preparation and maintenance of post-completion project files is suggested (*i.e.*, a single file kept on-premises or readily available, with essential project information, such as information sufficient to locate former employees and other witnesses knowledgeable about the project, contractor and subcontractor list, copy of plans and specifications, insurance information, and the like).
3. Old insurance documents (*i.e.*, prior policies insuring owner, developer, subcontractors) have new importance and value after cases such as *Montrose Chemical Corp. v. Superior Court*, 10 Cal.4th 645 (1995) (continuous injury trigger of coverage in third party insurance cases adopted).

B. Post-Completion Project Files

Preparation and maintenance of post-completion project files is suggested (*i.e.*, a single file kept on-premises or in easily-accessed storage with essential project information, such as information sufficient to locate former employees and other witnesses knowledgeable about the project, contractor and subcontractor list, copy of plans and specifications, insurance information, and the like).

³For a more detailed discussion, see “Implementing Effective Record Retention Policies For Developers”, *Journal of Construction Accounting and Taxation* (Summer, 1995).

XII. Handling Construction Defect Claims Pre-Litigation

A. Joint Experts?

Use of joint expert with the claimant or HOA sometimes may be advisable.

B. Early Retention of Consultants

Early retention of consultants is strongly recommended to obtain objective information about project conditions, possible repairs and costs. Care must be exercised to preserve attorney-client privilege and attorney work product.

C. Minimize Non-Privileged and Non-Protected Internal Communications

Rationale: internal investigations can be a fertile source of admissions, unwarranted speculation, and other damaging material.

D. Notify Other Parties

Notify contractors, subcontractors, design professionals, and other potentially involved parties, as well as their insurers and sureties.

E. Use Insurance Coverages

Insurance coverages carried by design professionals, subcontractors, and the developer is critical in settling construction defect claims pre-litigation.

1. Assemble and evaluate insurance resources.

- Collect and analyze additional insured endorsements and certificates of insurance; create insurance coverage matrix.
- Assess defense and coverage opportunities under insurance carried by subcontractors and design professionals.

- Assess defense and coverage opportunities under the builder's own insurance program.

2. Notify and tender to insurers for the builder and for other parties.

3. Analyze what the policies cover and do not cover in pre-litigation setting as well as in litigation.

4. Obtain insurers' concurrence in pre-litigation investigations, settlements, and the like, in order to avoid adverse policy conditions and exclusions (*i.e.*, "no voluntary payments" provision and the co-operation clause).

5. Develop "claim books" for each target party.

- Include focused statements of technical, factual and legal basis for liability and damages exposure.
- Level of detail will be dictated by the relative culpability and solvency of the target party.
- Include analysis of target party's insurance coverage and insurers' obligations to participate.

F. Tolling Agreements

The claimant may request a tolling agreement to suspend the running of statutes of limitations.

1. Elements of tolling agreements.

2. Be specific regarding the alleged defects to which the tolling applies.

3. Exercise caution to avoid prejudicing recovery rights against other parties and insurers, particularly where there is any question as to expiration of statutes of limitations or outside (ten year) limitations period.

G. Perform Comprehensive Internal Investigation

1. Assemble and evaluate builder's internal documentation.
 - Plans, specifications and drawings; as-builts, if any.
 - Contracts with design professionals and subcontractors.
 - All project files, including correspondence, memoranda, communications with public agencies, job logs, field notes, job diaries.
 - Photographs and videotapes.
 - Sales, escrow and customer service records.
2. Interview witnesses.
 - Current and former employees.
 - Terminated or otherwise hostile former employees.
 - Other parties' and public agency employees (*e.g.*, inspectors).
3. Informal discovery from design professionals, subcontractors, public agencies, and others.
4. Develop chronology/narrative history of the project.

XIII. Settlement

A. What Is The Builder's Exit Strategy?

Pay money or do work? Generally preferable to pay money and obtain a release. (Avoid tolling of limitations periods and disputes regarding completion of repairs.)

B. Releases

1. Release from whom? (HOA claims versus individual homeowner claims).
2. Release as to what? (Common area claims versus individual claims.)
3. Waiver/release of unknown claims. Can HOA release unknown future claims?

C. Other Settlement Issues

1. Consent by individual homeowners to settlement. Use of addenda (consent forms) to settlement agreement with HOA.
2. Indemnification by HOA against individual homeowner claims.
3. Board authority to settle (resolution ratifying settlement).
4. Use of recordable notice and memorandum of settlement. Ascertain from title company whether the recorded notice will appear as an exception on future preliminary reports.