

RISK MANAGEMENT STRATEGIES FOR RESIDENTIAL BUILDERS AND REMODELERS[®]

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Every residential builder and remodeler should be aware of the legal risks inherent in the industry and what can be done to manage these risks.

Historical Perspective

Implied Warranties

The litigious environment throughout the United States in residential construction began to evolve significantly in the mid to late 60's. Several lawsuits by homebuyers against their builders gave rise to court-made law, including implied warranties. Two common implied warranties that the courts imposed on the residential construction industry, despite the builder in a specific transaction never having stated any intent to offer either, are commonly known as the implied warranty of good and workmanlike construction and the implied warranty of habitability. The implied warranty of good and workmanlike construction focused on the way a house was built while the implied warranty of habitability focused on how the house performed after it was completed. Unfortunately, most courts failed to specifically define either implied warranty with any measure of certainty. The courts are admittedly not in a position to know the industry standards for construction, performance or warranty. This essentially left it up to juries, judges and arbitrators to decide if a house had been built properly or was performing adequately, or both, on a case-by-case basis. This has created a "battle of the hired-gun experts" type litigation.

Consumer Protection Statutes

Several states responded with statutory protection, providing another avenue for litigation against builders. Many of these statutory schemes provide that any violation of a warranty, express or implied, was a violation of the statute. Thus, a liable defendant-builder would be subject to a wide range of liability and damages, including a mandatory award of attorney fees to

a prevailing plaintiff-homeowner. But unfortunately, most of these statutory schemes provide virtually no meaningful defenses. Moreover, the builder rarely has a statutory right to inspect the house or to make an offer of repair that would resolve complaints fairly and discourage the homeowner's lawyer from filing a lawsuit. Under both the implied warranties and the statutory consumer protection statutes homeowners and their lawyers were incentivized to go to court in hopes of being awarded attorney's fees, court costs, expert costs, and sometimes punitive and exemplary damages. As one might expect, after implementation of these statutory provisions, residential construction litigation began to escalate as did the amount of the judgments against builders.

Builder Response to Consumer Protection

Some jurisdictions have responded with significant builder lobbying efforts to achieve their own industry statutory protections that have "notice and opportunity to cure" provisions. This often meant that a dissatisfied homeowner had to give his or her builder notice of all alleged construction defects and an opportunity to inspect the house before heading to the courthouse. Some statutes went further to give the builder a right to make an offer of repair before suit was filed, and if a reasonable offer was rejected, provided for penalties against the homeowner. The underlying purpose of these statutes was to encourage both the homeowner and builder to communicate openly and act reasonably in the resolution of construction defect disputes.

Seeking to bring some clarity and uniformity to the legal landscape of residential construction, some states created or assigned existing governmental bureaucracies to oversee the residential construction industry. Many states have some system providing for (i) registration or licensure of residential builders, (ii) mechanisms to discipline and administratively penalize builders who failed to comply with certain standards, (iii) registration of new homes or remodel jobs, (iv) mandatory pre-litigation exhaustion requirements of residential construction disputes between homeowners and builders, and (v) the creation of specific building and performance standards for residential construction.

Present Situation

Regardless of the jurisdiction, there are many steps that a residential builder can take to minimize risk and provide for their own protection, without the bureaucracy, without statutory protection or hoping that a judge or jury does the right thing in the courtroom.

Contractual Risk Management Strategies

The following is a list of suggested contractual strategies to help manage the potential legal risk in residential construction transactions. Of course, implementation of these suggestions is certainly no guarantee that a builder will not be sued by an unhappy customer. On the other hand, a builder who elects not to follow any of these suggestions is certainly increasing the odds of being sued and having to face the expensive, time-consuming and potentially ruinous effects of litigation.

1. Use Good Contract Forms

As any experienced builder knows, there are many different types of residential construction transactions. These include:

- (a) building on the owner's lot on a fixed price basis;
- (b) building on the owner's lot on a cost-plus basis;
- (c) sale of a completed home on the builder's lot;
- (d) construction and sale of a home to be completed on the builder's lot;
- (e) construction and sale of a partially completed home on the builder's lot;
- (f) remodeling on a fixed price basis; and
- (g) remodeling on a cost-plus basis.

It is critical that the right contract form and related addenda be used on each transaction. A contract is the "roadmap" of a construction transaction and must fully and accurately describe the terms of the deal. The days of the handshake deal are over, and simple contracts on old forms likely fail to meet present disclosure requirements and merely give builders a false sense of security.

2. Provide a Comprehensive Express Warranty

In many states, an implied warranty of good and workmanlike construction and an implied warranty of habitability will apply unless properly disclaimed by the builder and waived by the buyer/customer. Some jurisdictions do not allow waiver of these implied warranties.

A good warranty should have language that disclaims any implied warranties to the extent allowed by applicable law and provides an express warranty on the home that, for the most part, contains the same construction standards as are acceptable in the jurisdiction where the construction is located. Generally, the warranty could provide coverage as follows:

- (a) one year coverage on workmanship and materials;
- (b) two years coverage on electrical, plumbing and mechanical systems; and
- (c) ten years coverage against “major structural defects.”

If available, a builder should always provide warranty coverage through an independent third-party warranty company (a “TPWC”). If the builder elects to provide a warranty backed by a TPWC, the sales contract should state that the third party warranty will be the primary warranty on the home and that the builder’s own express warranty will not come into play unless a particular problem is not covered by the third party warranty.

Using a TPWC to provide primary warranty coverage on a home is an excellent way for a builder to transfer risk, especially if the warranty provided through the TPWC has the same basic warranty coverage as the builder’s own warranty. Since the builder remains ultimately responsible if the TPWC doesn’t take care of the warranty claim, the builder should confirm not only the scope of the third party warranty but also that the TPWC has sufficient resources and assets to satisfy its potential warranty obligations. In other words, a builder should select a TPWC that is backed by a good insurance program which insures the TPWC’s warranty responsibilities.

3. Use Binding Arbitration for Dispute Resolution

Building or remodeling a residence is an extremely complex and technical process. When something goes wrong with a house after completion and occupancy it is usually not easy to quickly determine the cause(s) of the problem and who is responsible. Since homeowners will rarely accept any responsibility, the builder is usually the first and only target unless there is a TPWC or viable subcontractors involved, or both.

The resolution of construction defect disputes through litigation is a long, tedious and expensive process typically lasting several years, especially if one of the parties demands a trial by jury. Before the case can go to trial, all the parties usually spend years exchanging written discovery, engaging expert witnesses, taking depositions and filing and responding to various pre-trial motions. The jury trial of a construction defect case can last from one to four weeks depending on the number of issues and parties involved.

When the case finally does go to trial, the actual jury selection process is used by the plaintiff’s lawyer to eliminate as a juror anyone who has any technical knowledge about or experience in residential construction. As a result, jurors in residential construction cases are

predominantly lay people who typically identify with the homeowner, know nothing about construction and who quickly become confused and/or bored by all the conflicting reports, the testimony of the parties' experts and the courtroom arguments of the lawyers. As a result, juries in these cases have a tendency to be swayed by emotion and empathy more than by technical evidence. In sum, juries are nearly exclusively made up of homeowners, not builders, and a jury made up of homeowners is not a jury of a builder's peers.

Binding arbitration offers a viable, common-sense alternative to jury trials for resolution of construction defect disputes. The courts have long held that, with a few limited exceptions, written agreements to arbitrate are binding and enforceable. There are several advantages to all parties for going to arbitration rather than trial. These include the following:

- (a) Arbitration is quicker than litigation. A case can usually be resolved through arbitration within twelve months from the initial filing of the arbitration.
- (b) The cost involved to take a case through arbitration is usually much less than going all the way through a jury trial.
- (c) The fact-finder in an arbitration is normally an individual who possesses some substantive knowledge about residential construction and the laws impacting it. Consequently, decisions in arbitration are based more on the facts and less on emotion.
- (d) Arbitration is a private proceeding and not "open to the public" like a jury trial.
- (e) The arbitrator can visit the house to personally view the construction. This enables the arbitrator to get a better and more independent understanding of the contested issues. Most juries and judges are not permitted to go to the house and instead must depend on photographs or videos that have usually been carefully selected and/or edited by the parties.
- (f) In most cases, the arbitrator's award is final and not subject to appeal or judicial review. In jury trials, the losing party frequently files a motion for new trial and, if unsuccessful, an appeal. The appeal of a judgment based on a jury verdict can go on for years and frequently results in the case having to be tried again by a different jury.

Many current versions of industry contracts contain a binding arbitration clause whereby the parties agree that all disputes that are left unresolved after negotiation and mediation will be

submitted to binding arbitration. Most TPWC documents also contain binding arbitration clauses.

4. Use Good Independent Contractor Agreements

In today's residential construction industry virtually all of the labor and materials from design of the foundation through final finish-out, is provided by independent contractors or subcontractors rather than by employees of the builder. Notwithstanding this fact, it is the builder who contracts with the customer and who warrants the performance of the structure. For this reason, it is extremely important for the builder to have written agreements with its independent contractors and subcontractors whereby the risk associated with defective work or materials is transferred to the responsible party. Most builders fail to realize that their subcontractors understand the need for clear contracts that facilitate continuing business with the builder.

The independent contractor agreements should contain a number of key clauses that help protect the builder. These include:

- (a) a requirement that the independent contractor have and maintain a policy of liability insurance with adequate limits that lists the builder as an additional insured;
- (b) an express warranty by the independent contractor covering its labor and/or materials for a time period equal to the builder's warranty to the customer;
- (c) an express indemnity clause whereby the independent contractor agrees to indemnify the builder against any liability or damages arising out of defective labor or materials provided by or through the independent contractor;
- (d) a binding arbitration clause designed to allow the builder to compel the independent contractor to participate in any future arbitration proceeding between the builder and the homeowner resulting from allegations of defective construction by that contractor;
- (e) language that gives the builder ways to protect itself against situations where the contractor gets paid by the builder but fails to pay the persons or companies that supplied labor or materials to the contractor.

A builder in today's legal climate would be well advised to use a good set of independent contractor agreements on all construction projects.

Best Practice Risk Management Strategies

The following is a list of suggested best practices to help manage the potential legal risk in residential construction transactions. Of course, implementation of these suggestions is certainly no guarantee that a builder will not be sued by an unhappy customer. On the other hand, a builder who elects not to follow any of these suggestions, is certainly increasing the odds of being sued and having to face the expensive, time-consuming and potentially ruinous effects of litigation.

1. Operate as a Business Entity

Back in the "old days," many builders operated as sole proprietors. That means that they built and sold houses in their own name rather than through a separate business entity. This practice has virtually ceased among all but the most unsophisticated builders because operating as a sole proprietorship exposes the individual's personal assets to all the liabilities arising out of the business operations.

In today's legal environment a builder should operate exclusively through a duly formed business entity such as a corporation or a limited liability company. It is beyond the scope of this paper to go into a detailed discussion of the various types of legal entities and the relative advantages and disadvantages of each. There are also tax issues to be considered when selecting an entity. These matters should be discussed with legal counsel and tax advisors.

Of course, setting up the legal entity is only the first step. It is also advisable to follow the legal requirements for maintaining the entity. With respect to a corporation, for example, this means following all of the corporate formalities such as issuing stock, having written bylaws, having annual meetings, keeping minutes of meetings, electing officers and directors and establishing and using a corporate bank account. These formalities may sound imposing, but they can be easily managed.

If properly formed and maintained, a business entity can be a very effective "firewall" against legal liabilities from business operations.

2. Maintain Adequate Insurance Coverage

Insurance is another important component of a comprehensive risk management plan since a good commercial general liability (“CGL”) policy will indemnify the builder for losses such as “bodily injury” and “property damage.” A detailed discussion of insurance coverage is another topic that is complicated and beyond the scope of this paper. The builder is advised to consult with a licensed insurance professional to learn more about insurance coverage and costs.

But generally, some of the potentially significant risks that confront builders include the following:

- (a) Completed Operations – property damage and bodily injury claims that arise from construction defects and/or faulty workmanship after the home is sold or the construction project is completed;
- (b) Third party injury to job site personnel or the general public at the job site during the construction process;
- (c) Damage to property near the job site as a result of the builder’s construction activities; and
- (d) Environmental or pollution liability from operations or equipment used during construction.

All of these risks and others can be covered by a comprehensive CGL policy.

In selecting a CGL policy, a builder should always verify that the coverage includes losses arising from the activities of independent contractors and subcontractors. This is important because many CGL policies on the market today do not provide completed operations coverage for damages caused by independent contractors or subcontractors.

The builder should also consider whether or not to add “additional insured” coverage to the CGL policy to protect individuals and business entities affiliated with the insured entity that is building the project. There is an additional charge for this coverage but in this era of “dragnet” litigation, it may be a wise investment.

A good CGL policy can work in conjunction with an insured third party warranty program to transfer a significant portion of the potential liability risk attendant to residential construction projects. Warranty coverage is designed to transfer the cost of correcting warranted defects. The CGL policy protects the builder from the often significant costs of defending a legal action arising from a covered claim and also will indemnify the builder against covered losses.

Another type of insurance that should be utilized in appropriate circumstances is “builder’s risk” insurance. A builder’s risk policy is a more limited type of insurance coverage that is designed to indemnify the builder against specified losses such as fire or theft occurring during a construction project.

3. Use Common Sense

There is no substitute for common sense when one is trying to earn a living in an industry which has as much potential legal risk as residential construction. The following is a non-exclusive list of “common sense” suggestions gleaned from years of experience in residential construction disputes:

- (a) Select your customers very carefully. This is certainly a two-way process. Try to get to know a potential customer before signing a contract. The goal here is to try to avoid selling to “high risk” customers that will be overly demanding, unreasonable or impossible to satisfy. If the customer is unreasonable in negotiations, the customer is “high risk” and can be counted on to continue the pattern as concerns arise during construction. In tough economic times and with the already tight builder profit margins, selling to a high risk customer is never worth years of litigation.
- (b) Obtain and review all available site information and specific city requirements before construction begins and share this information with the appropriate independent contractors, subcontractors and design professionals. This information could include soil reports, aerial photos, subdivision grading plans, elevations, drainage maps, easement locations, deed restrictions, etc.
- (c) Always document changes in the work with written and signed change orders before the work is done.
- (d) Be meticulous in accounting for all money used on the job. If the builder’s jurisdiction requires, establish and maintain the required construction or trust account, as some statutory provisions have criminal penalties if a proper accounting is not provided.
- (e) From the very beginning, educate your customers on the warranty that you will be providing to them. Give them a copy of your warranty and, if applicable, a specimen copy of the warranty to be provided by a TPWC. Take the time to go

over the applicable express warranty with the customers so that they will have a clear understanding of what is covered and what is not covered and all their maintenance responsibilities after occupancy.

- (f) Conduct a walk-through with the customer and obtain their signature on an acceptance form at completion/closing that acknowledges inspection, adequacy of construction and releases all claims except those arising under the express written warranty given on the house.
- (g) Respond promptly and politely to all warranty requests and keep a record of all customer complaints and warranty requests, as well as your responses.
- (h) Obtain a criminal background check on all employees, agents and individual subcontractors who will be entering a customer's residence after occupancy. A builder's liability in such situations can extend beyond mere broken items and could result in more serious financial and personal liability
- (i) Maintain and archive all of your construction documents on every project for at least ten years after completion.
- (j) If you receive written notice of a construction defect claim, follow the appropriate statutory steps, if any.

Conclusion

The legal environment for residential construction has changed significantly over the last forty years as a result of legislative and court decisions. This pattern of change will likely continue in the future. A builder who wants to survive financially, let alone thrive, must continually stay abreast of legal developments in the industry and adapt to them.

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