PROTECTION FROM PERSONAL LIABILITY FOR CONSTRUCTION DEFECT CLAIMS

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Lawsuits alleging faulty construction of residential products have long plagued developers in California. Despite the 2002 enactment of SB-800, sweeping legislation intended to minimize, streamline, and curb construction defect litigation by giving developers the right to repair construction defects, there has been no reduction of construction defect litigation in California. The recent development of wrap insurance policies has not resulted in greater protection or coverage either. Instead, developers are facing more personal liability for construction defect claims than ever before. This article briefly discusses the history of construction defect litigation and applicable insurance and then explains the current dispute resolution framework and insurance policies. Thereafter, it identifies and proposes solutions for some of the issues that developers will have to address in order to avoid or minimize their personal exposure to construction defect claims.

In light of today's financial crisis, this article is equally applicable to construction lenders who foreclose and sell projects as a result of the broad definition of a "Builder" under SB-800. A more in-depth analysis regarding the Lender's exposure under SB-800 can be found in the firm's article entitled "Long Term Construction Defect Liability Claims May Await Lenders Who Foreclose on New Condominium and Tract Housing Projects in California."

BEFORE SB-800

Historically, when a homeowner or a homeowners' association felt that there was a defect in construction related to the development of their property, they filed a lawsuit against the developer. The developer, in turn, notified their insurance carrier of the claim then left it to the insurance company to resolve the matter. The resulting litigation was a struggle between the insurance company for the developer and the insurance companies for the general contractor and the subcontractors, who would each try to minimize their own liability and the amount they were going to pay the plaintiffs for damages. Upon resolution of the matter, the developer's insurance company would notify the developer of the results of the litigation and

request payment of the developer's deductible on the policy. Often, the competing interests of the defendant development entities would actually provide all the evidence needed by the HOA to substantiate their claims for damages.

POST SB-800 AND WRAP INSURANCE

Prior to SB-800 the developer was provided notice of the potential claim under certain circumstances (Calderon Notice pursuant to Civil Code section 1375) prior to the initiation of any lawsuit but could not effectuate any repairs at the project. The building industry and insurance carriers viewed this process as problematic and unproductive. As a result, they lobbied the legislature to enact SB-800 to provide the developer with a pre-litigation procedure to resolve construction defect claims. This means that today a homeowner or homeowners' association cannot just file a lawsuit if they have a claim of faulty construction. Instead, the developer has to be notified of a potential claim giving the developer the right to repair before litigation can commence. Around the same time, insurance companies created "wrap insurance coverage". Wrap insurance was a new type of insurance coverage for the residential construction industry with the stated goal of protecting the developer while avoiding the costly and counterproductive battles between defendants. Wrap insurance policies are designed to provide protection from construction defect liability for all potential defendants, namely the developer, general contractor and sub-trades. It was believed that this new form of policy would eliminate infighting between the defendants so that all resources could be concentrated on defending the action, minimizing liability, and reducing overall damage claims.

NEW CHALLENGES

Inadequate Policy Limits

Theoretically, wrap insurance was a good idea, but the result has been less than optimal for the insured parties. Due to the high costs associated with these policies and the unrealistic exposure expectations of the insured parties, many projects have been under-insured. Prior to wrap policies as previously discussed, there were multiple policies available to pay claims. For example, if the developer and nine of the subcontractors each had a $1 million policy, there was theoretically $10 million of available coverage. Now, if the developer gets a new wrap policy with the same million dollars in potential coverage, there is $9 million less in coverage to

pay claims. The result has been inadequate policy limits to cover actual claims in many instances.

Burning Limits Policies

Compounding the issue of sufficiency of insurance is the fact that most wrap insurance policies reduce policy limits by the cost of the attorneys and experts fees retained by the insurance company, a practice known in the industry as "burning limits". Litigation fees and expenses can run into the hundreds of thousands of dollars, the net effect being that the developer and the other implicated parties will face increased exposure for construction losses.

Self-Insured Retentions

Wrap insurance policies typically apply a self-insured retention (SIR) which requires the developer to go out of pocket *before* the insurance carrier has any responsibility to defend an action. This is an important distinction between a SIR and a deductible. In the case of policies with a deductible, the insurance carrier has an immediate obligation to retain an attorney to defend the insured. Upon resolution of the action, the carrier requests the amount of the deductible from the insured. In the case of most wrap insurance policies, the developer has to "satisfy" the SIR before the carrier has any obligation to hire an attorney to defend the developer. Coming up with these funds at the beginning of the dispute resolution process can be difficult for many developers, especially in tough economic times. It should be noted that a developer can typically satisfy the SIR by *either* direct payment to the carrier *or,* as explained below, directly incurring legal and expert fees. In other words, the Seller can hire their own attorney and experts and use those incurred invoices to satisfy the SIR in most circumstances, rather than just issuing a check to the carrier.

Pre-Litigation Coverage Disputes

Another issue faced when dealing with the new SB-800 pre-litigation procedures is the triggering of coverage and the responsibility of the insurance company to pay for pre-litigation repairs. Many of the policies state that coverage commences upon the filing of a "suit" and many insurers argue that the pre-litigation procedures in SB-800 are not included in that definition. When this issue has come up, the courts have relied upon the policy language and the definition of "suit" to determine if coverage is triggered by the pre-litigation procedure. A developer may have to spend time and money on review and advocacy related to coverage in

order to resolve a dispute and still take advantage of SB-800's right to repair provisions. Once again, the associated attorney and experts cost incurred during the SB-800 process can often times be used to satisfy the wrap policies' SIR.

Defect Claims v. Covered Claims

If the wrap insurance carrier determines that the claim is covered by the policy, a "Reservation of Rights" letter will generally be issued indicating the extent of coverage for the particular claim. In order to position the litigation appropriately, this Reservation of Rights letter should be reviewed very carefully, and the developer's counsel should position the case so that any damages paid are covered by the policy thereby limiting personal exposure.

BEST PRACTICES

In a perfect world the best practice would be to avoid construction defect litigation altogether. One simple step a developer can take to help avert construction defect claims is to make sure that all the necessary customer service is provided to the homeowners. In some situations, it would benefit the developer to have a representative attend the homeowners' association meetings to assist the board in addressing construction related issues. Some developers have also found it beneficial to periodically correspond with the homeowners' association to make sure that they timely perform the required maintenance regimen.

Handling of a claim upon notice of a construction defect claim is also critical. First, the terms of the wrap insurance policy should be reviewed to determine the insured's payment obligations related to the claim. In the rare cases where the insured is obligated to pay a deductible, the wrap insurance carrier will have an immediate obligation to defend the action. More likely, the policy will require the payment of an SIR amount which must be paid directly to the carrier, as previously explained, or towards legal fees and costs incurred by the developer before the insurer's defense obligations begin. It is our recommendation in many cases that the developer retain their own counsel and expert in order to satisfy the SIR. By doing so, the developer is likely to minimize exposure.

It is imperative that the payment obligation (deductible vs. SIR) be determined up front so that the insured can minimize unnecessary expenses and maximize the benefits of the wrap insurance policy. Under both circumstances, the wrap insurance carrier should be provided

notice of the claim. This notice should be carefully tailored to ensure coverage under the wrap policy.

Developers should also consider hiring personal counsel, the cost of which can typically be used to satisfy the SIR, to advocate on their behalf. Simply put, failure to properly address these issues can result in significant personal liability for a developer and/or denial of coverage by a carrier.