

## **WHY BUILDERS AND CONTRACTORS INCLUDE RISK TRANSFER PROVISIONS IN THEIR CONTRACT FORMS**

In this *Business Insights* issue, we will highlight some of the reasons that builders and general contractors feel compelled to include very one-sided risk transfer provisions in their customer contract forms.

Developments in tort law have left builders and general contractors exposed to large claims. Builders face property damage claims in construction defect litigation lawsuits on one hand, and catastrophic bodily injury claims on the other. Builders and general contractors often become the targets of lawsuits even when only indirectly at fault. In other words, the builder did nothing affirmative to contribute to either the property damage or the bodily injury for which it was sued.

Let's take a look at an example of a bodily injury claim asserted against a builder in which the fault of the builder is in doubt. Due to the severity of injuries and the prospect of losing a big-dollar case, even though the probability of losing is not significant, the builder and its commercial general liability insurance company in our example choose to settle.

### **CASE BREAK:**

A builder is nearly finished with the construction of a two-story residence. The clean-up subcontractor is one of the last trades involved in the construction. One day, the clean-up crew is short one person and hires a day laborer with no experience. The builder is unaware that this person has been hired. The day laborer is told by her new employer to go into the attic and remove paint from the interior of the attic dormer windows. In the process, the day laborer steps between the roof trusses and falls through the second floor ceiling to the ground and sustains serious debilitating injuries. The inexperienced laborer did not know she could not stand on the drywall that made up the ceiling of the second floor.

A lawsuit is filed against the builder. The builder is alleged to be negligent based on the fact that it did not place controls on the clean-up subcontractor. This negligence is asserted even though the builder did nothing to directly contribute to the injury. Due to the severity of the injuries and the high possibility for an adverse verdict, the builder's insurance carrier contributes its insurance policy limits to a settlement. Had the lawsuit not been settled, the builder would have faced defending a multi-million dollar claim that may have far exceeded its insurance policy limits, significantly exposing its net assets, and possibly caused the builder to file bankruptcy.

Builders frequently face these types of large-dollar claims for personal injury and property damage. Remember, constructing homes involves some dangerous work. Fortunately, to some extent, the trend toward expanding the builder's liability has been checked in recent years. Through the intense lobbying and legislative efforts of both the National Home Builders Association and regional homebuilder associations, some states have implemented broad tort reform. This type of legislation has helped builders on two fronts. First, it has reduced their liability potential. Second, it has restricted the dollar amounts that can be recovered in some lawsuits. But, despite these positive developments, the risk of bodily injury and property damage claims filed against builders and general contractors remains significant.

The risk of construction defect litigation claims is even more significant than the risk of personal injury claims. For example, one California law firm's web site posted its successes with construction defect litigation settlements over a five-year period as totaling more than \$220 million. That averages out to more than \$3.7 million per case. Because plaintiff lawyers are usually hired on a contingency fee basis, the average attorney's fee per case paid to this firm was approximately \$1.5 million. Without a doubt, there is a great deal of incentive for lawyers to file these kinds of lawsuits.

Because of the increasing number of construction defect litigation cases, some homebuilders have adopted an attitude of "If you build it, they will sue." Not only do builders face the possibility that homeowners may sue years later for alleged defects in design or workmanship, it is also not unusual for a builder to face a lawsuit from a group of homeowners from the same subdivision. These lawsuits can result in multiple plaintiffs asserting multiple claims and seeking millions of dollars in damages. Construction defect litigation is serious business to homebuilders, particularly in the Western U.S., Texas, and Florida.

The amount of money builders expend to defend construction defect suits is outrageous. Contributing to these high costs are complex legal concepts, broad discovery that is permitted, required experts, and guaranteed insurance coverage disputes. With the combination of these factors, plaintiff lawyers intend to make the case more difficult and more expensive for the defense. As a result, it is common for the defense to opt to settle the case instead of continuing the litigation. This may occur even when the claims can be defended and defeated. Because of their complexity, once a construction defect lawsuit is filed, the insurance industry reports that 40 to 60 percent of all monies expended compensate the defense lawyers and their experts.

When facing the significant risks posed by construction defect litigation, one way for the builders to protect themselves is through risk avoidance. While risk avoidance is rather simplistic from the builder's perspective, it is not practical for most builders. Risk avoidance to a builder essentially means "We don't need to be in this business." Some builders have taken this approach either deliberately or through evolution. These builders essentially spend most of their time buying and developing land, and leave the construction to large trade contractors and suppliers. This may not mean risk avoidance entirely, but by using large enough trade contractors and suppliers, and appropriate risk transfer mechanisms, they can greatly reduce their risk.

In any event, most builders spend a great deal of time and money developing means to transfer risk to their subcontractors and suppliers. From the builder's perspective, they are protecting themselves far better now than in the past. They now use clear—albeit one-sided—contracts. These contracts include indemnification provisions, require broad additional insured endorsements, and impose very one-sided and broad insurance requirements. Once developed, builders request that all of their subcontractors and suppliers sign these contracts, often indicating that no changes are permitted. Although perhaps the builders and general contractors have legitimate reasons for imposing risk transfer on their subcontractors and suppliers, it seems that in many instances they have gone too far. This is especially true when they request that their suppliers agree to provisions that are only applicable to onsite subcontractors. This often puts suppliers in a precarious situation where they are asked to accept risk for things outside their scope of work.