

Home Warranty Insurance: Best Practices, Risks and Recommendations

With Appendix of Sources and Suggested Reading

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Introduction

Buying a new home is the largest financial transaction most people will ever make and it is often done on blind faith. Faith that the builder is qualified, that the land is environmentally safe, the construction materials are durable and the design appropriate for the intended use. Unlike buying a car or computer system, there is no way to warranty or buy insurance for quality workmanship and durability. It is primarily a “buyer beware” market where a mistake can seriously impact on the financial, mental and physical well being of the household for many years, even a lifetime.

This has not stopped, or even slowed new home construction and ownership. According to Consumer Reports.org, consumers bought more than a million new homes in 2004 at an average sale price of \$250,000. Alan Mooney, president of Criterium Engineers, a consulting-engineering firm with offices in 35 states, estimates 15% of new homes have serious problems that show up months or even years after completion, causing homeowners to spend millions of dollars on repairs. Defects range from faulty foundations and leaky cellars to mold, gaping cracks, rotting walls and doors that cannot close. Mooney adds “I don’t think many of these houses will last 50 years.”

Mooney and others identify several underlying causes including;

- the need to keep expenses down despite the rising cost of goods and services
- complicated home designs to meet environmental and energy efficiency guidelines
- increased speed to market with 60 to 90 days turnaround from ground breaking to move-in
- labor shortages of qualified trades people such as framers, plumbers, electricians, and inspectors
- language barriers between foremen and crews
- shareholder pressure on large builders to be more profitable

Despite growing dissatisfaction among homebuyers there are only 30 states with legislated building codes, and even in these states enforcement is lax or non-existent. Understaffed and over-burdened, home inspectors cannot meet demand. In 23 states, inspectors are not even licensed or regulated. Consumer affairs departments can investigate home building fraud, but give it low priority. The Better Business Bureau can take complaints, but it cannot force builders to make repairs.

Some builders offer home warranties to increase consumer confidence, but only 10 states regulate the programs or post bonds to secure performance. While most builders contend

they respond quickly to complaints in order to maintain their reputations, dissatisfied owners are on the increase.

Viewed as a political “hot potato”, and sensitive to objections from an industry that produces billions of dollars in tax revenue annually, federal interest in regulating the industry or implementing a warranty program has been limited. The Federal Trade Commission has not filed suit against a builder for faulty construction in more than a decade. Consumers groups are demanding recourse and their loss of confidence in the construction industry, coupled with surging costs to build, eventually may lead to a national new housing crisis.

This is not a new problem, nor is it unique to the United States. Other countries face similar concerns and several, including Australia and Canada, have implemented home warranty insurance schemes. Before reviewing the pros and cons of these programs, it is necessary to take a look at multi-family for-sale housing and condominiums. This market has been hit hardest by defect litigation and is feeling the repercussions of insurance regulation, not dissimilar to that of the aforementioned home warranty programs.

Industry Snapshot of the Multi-family/Condominium Market

Explosive growth in residential construction is driving an increase in defect litigation in multi-family for sale housing and condominiums. Owners, often left without recourse to original sellers, sue the developer, contractor and the architect for defects in construction, design and maintenance. Developers and contractors maintain that many of the lawsuits are frivolous and can be resolved without litigation, while plaintiff law firms blame poor quality construction and shoddy workmanship. Developers want to limit the ability of aggrieved parties to sue, while the other side maintains litigation is the last resort for frustrated homeowners.

Other factors also contribute to increased defect litigation. Acts of nature, such as earthquakes and hurricanes result in damage that may be linked to construction or design flaws. Environmentalists express concern about construction taking place on land that has been marginalized and may lead to defects or health related hazards. Add in the move to more elaborate “smart” buildings, embedded technology and heightened security measures, and the opportunity for lawsuits seems to be growing.

The cost of litigation is becoming prohibitive for many stakeholders, especially for condominium construction which carries unusual risk factors and a higher number of claims. Monetary settlements for high rise condominiums where many units in the same building sue for common defects can be in the millions. Although the vast majority of cases are settled before reaching court, the typical award is between \$1 and \$2 million, with one large settlement reaching \$34.5 million. If the case goes to trial, legal fees for all parties involved add significant expense, often resulting in costs in excess of repairs.

In addition to higher settlement costs, condominium construction has a higher number of claims. The AIA Trust White Paper: [Risk Management for Condominium Projects](#) refers

to a university study in which 1/3 of all condominium projects reported construction defects and almost 40% had “major flaws”. Further, the study states that 14% of condo owners interviewed had already filed claims against the developer, 12% had threatened a lawsuit and one out of every five claims against insured architects/engineers involves a condominium project.

In order to minimize financial exposure, contractors are forced to obtain commercial general liability insurance policies to protect against tort liability to others, bodily injury, property damage indemnification for investigation and defense costs. However, obtaining coverage is becoming increasingly difficult, as well as expensive. Many insurers for contractors have removed standard coverage for all residential construction from the standard GLC insurance policy. When a firm goes for policy renewals, professional liability insurers may require a Supplemental Application form that evaluates exposure for condominium projects and raises rates or discontinues coverage if the risk assessed is greater than established guidelines. For example, an insurer may deny coverage to a firm if condos are 20% or more of annual revenues and it is not unheard of that even 5% will trigger higher premiums or higher deductibles.

Some insurers simply chose not to renew residential contractors while others raise rates and closely monitor underwriting practices, especially in states with aggressive construction, such as California. Construction Defect Litigation and the Condominium Market by Roger Dunstan and Jennifer Swenson states that insurance company representatives announce publicly “they will not underwrite contractors in California who have worked on a condominium or multi-family project within a time period that may leave them subject to litigation.” Overall, this study concludes that construction defect insurance in California appears to be more expensive and less generous than other states, though the causes are unclear and may include higher housing costs as well as more lawsuits.

Architects as well as contractors are adversely affected by the increase in defect litigation. Viewed at higher risk than engineers because they hold the primary design contract, architects have seen similar rate and deductible increases, and like large contractors, architectural firms are considered to have “deep pockets.” Owners and contractors may try to pass blame on to the architect, stating that designs are flawed or that the architect failed to correctly inspect and identify construction problems. And if the developer or contractor cannot be sued, the architect may become the “last man standing” thus bearing the brunt of the litigation.

The exact cause of the increase in defect litigation, indeed even the size of the increase, is difficult to prove because of inadequate tracking data for condominium construction, insurance rates and construction defect cases. What can be documented are the effects. Increased liabilities, higher insurance costs, the difficulty in obtaining financing and new contract exclusions have forced many developers, contractors, architects and professional liability insurers to abandon the multi-housing market. This runs counter to public policy that advocates a move to “smart growth” high density communities that will conserve natural resources and provide affordable housing for fast growing populations.

It also denies the steadily growing demand for more condominiums. *Realtor Magazine* reports that “Condos now account for 12.8 percent of the housing market, a 33.3 percent rise over the last decade.” The March 2005 Multi-family Housing Market Index, published by the National Association of Homebuilders states “Condos are the strongest category in multi-family construction.” A January 2006 article quoted in Risk Management for Condominium Projects states “there are 60,000 condominiums and 19,000 condo-hotel units currently proposed, planned or under construction in the Las Vegas Valley.”

The critical need to build multi-unit housing is driving a nationwide search for defect litigation solutions to meet the requirements of owners, contractors and insurers. Several states, including California, are enacting legislation to minimize law suits, define liability, establish reasonable statutes of limitation and improve quality of construction.

To date, legislation has been on a state-by-state basis, with little uniformity and increasing complexity, however there has been some progress in gaining agreement. As of January, 2006 twenty-seven states have passed the “Right-to-Cure” Acts or Construction Defect Acts that require HOA (Home Owner Associations) and unit owners to give advance written notice of a defect to the contractor, allowing inspection, testing, repair or deniability, before filing lawsuits. Another popular piece of legislation is the Uniform Condominium Act (1980) which has been enacted in 15 states, with variations adopted by several others. The “UCA”, drafted by a committee of lawyers, seeks to promote uniformity among the laws of the 50 states, making it easier for architects and all stakeholders to understand and conform to condo law. Under this plan, developers provide an express warranty to the physical characteristics of the plans/specs of the project, and create an implied warranty as to quality. Developers may reduce the statute of limitations from 6 to 2 years with a separate disclaimer agreed upon by both parties. The goal is to manage risk.

California has passed several bills to address risk and liability. SB1029 which requires arbitration prior to filing of litigation has met with limited success and is most often criticized for prolonging the process with similar outcomes. The recently passed AB758 restricts the indemnification contract provisions that can be included in residential construction contracts and prohibits a developer from requiring a subcontractor to defend and hold harmless the developer for defects caused by others. In other words, the subcontractor is responsible only for his own work. SB 800 establishes construction standards and allows the developer the right to repair before litigation can commence. The effectiveness of these bills is yet to be determined.

The overriding fear is that problems plaguing condo development will spread to the residential housing market as a whole, and construction insurance will be increasingly expensive and difficult to obtain. Evidence to that effect has already surfaced in California and Nevada where rising premiums and risk factors led several home builders and large insurers to move out of state, and in Texas, where insurers refused to provide coverage when local government attempted to cap premiums.

Rather than continue to enact legislation on a bill by bill basis, a process that at this juncture can be compared to rearranging deck chairs on the Titanic, it has been suggested that a universal home warranty insurance program, such as the ones used in Australia and Canada, may help alleviate the current litigious climate, lead to higher quality construction, reduce long delays and provide protection for all stakeholders. **However, it must be noted that since 2003 these home warranty programs do not cover multi-family or condominium housing because of the increased risks involved.**

Home Warranty Insurance Plans

Home warranty insurance, also known as builders' warranty, building or housing/home indemnity insurance, is primarily designed as a "fall out" system to reduce consumer loss as a result of defective or incomplete building. Implemented in Canada and Australia during the 1990s, administration, funding, standards, remedies and support differ by state and region and have met with varying degrees of success. The plans share certain basic goals and tenets. Simply stated, home warranty programs should:

- regulate the building industry by identifying a code of standards which builders must meet;
- create a reasonable balance between the interests of building contractors and consumers;
- offer remedies for defective building materials and workmanship; and,
- provide support, education and advice for all stakeholders including developers, contractors, designers and owners

Additional criteria that has been added over the years include:

- create a realistic, fair and transparent insurance framework;
- eliminate unreliable and unethical contractors from the industry;
- establish and enforce clear building rules;
- early intervention and resolution of disputes, and,
- establish a third party group to act as intermediary among stakeholders

There are two distinct approaches to home warranty insurance. The first approach, used in New South Wales and Victoria, Australia is to legally license insured builders and then use private insurance companies to underwrite policies. The second approach, used in Queensland, is to use a third party, government controlled entity to provide all aspects of home warranty including licensing, enforcement, mediation and insurance. British Columbia, Canada uses a hybrid system of government control and private funding. Sources agree that the Queensland program is the most successful.

New South Wales and Victoria

New South Wales (NSW) and Victoria have the two largest home warranty insurance schemes in Australia and their programs account for about 75% of the market. All residential building work over the value of \$12,000 must be covered by a contract of insurance, and a copy of the certificate must be given to the client. There are strict penalties in place for builders and owners if they try to circumvent the system. Warranties are valid for the construction phase, then 2 years for non-structural defects and 6 years for structural. Despite the good intentions, the programs have been only marginally successful and are often criticized as doing more harm than good to the industry.

Both started out as government funded insurers and both privatized in the mid 1990s. The idea at the time was that competition and private market forces would bring down costs and improve overall management. However, the collapse of the major insurer in March 2001, along with market uncertainties and the downturn in international share markets after 9/11, caused massive upheavals in the insurance industry that left many home builders seeking coverage from a shrinking pool of companies. Finally, by 2002, only one insurer remained, creating a monopoly. Requirements for builders became increasingly difficult, premiums skyrocketed, and new residential building starts faced months of delay.

The governments responded in 2002 by amending many of the home warranty requirements, changes which were intended to placate insurers and still ensure builders could get the mandatory insurance. However, many of these changes, such as making the insurance one of “last resort”, which means it kicks in only if the builder has died, disappeared or become insolvent, rendered the insurance almost useless. Raising the threshold for mandatory insurance, reducing the period of coverage, excluding multi-family dwellings and buildings over three stories tall while limiting maximum payouts to 20% of the contracted price for uncompleted work and an overall cap of \$200,000 per project, further reduced insurer risk. And yet, at the end of 2004 only three insurance companies were willing to write coverage and 59% of builders could not get insurance.

In addition to the difficulty of finding an insurer, builders complain about long delays waiting for their applications to be approved, strict financial tests that must be passed to establish eligibility and, if assets are deemed insufficient, the need to provide a bank guarantee. Emphasis is placed on financial viability rather than quality workmanship or recommendations. Smaller builders, unable to meet the financial thresholds are forced to leave the industry or work for larger firms. This has reduced competition and driven up costs. Owners, faced with the choice of delaying projects waiting for approvals or going with more expensive alternatives, have seen their expenses increase.

Architects are also adversely affected by tight insurance industry guidelines and requirements. In an effort to limit risk as much as possible, some insurance carriers have barred contractors from building architect designed housing because they fear new and untried design concepts may lead to flaws, defects and more liability. This makes it

virtually impossible for architects to create solutions to energy and environmental concerns and everyone, including the consumer, suffers from old, outdated designs.

When builders are unable to meet the requirements they look for exclusions to the mandatory insurance. One very popular loophole is to split contracts with owners and take out an owner-builder license. The owner takes on the full responsibility and risk of the building or renovation, and the contractor acts solely as an unpaid advisor. This option puts the owner at risk. If there is intent to sell the property within 6 years, insurance is still mandatory and if an owner needs to sell within that timeframe, they may find it almost impossible to do so without evidence of insurance.

Insurance oversight is primarily done by the industry itself, leaving very little recourse for either builders or consumers. Architects in particular suffer because owners blocked in their attempts to collect from contractors may be able to file and win claims for loss or damage due to faulty design. In a response to calls for government intervention, NSW created the Fair Trading Office Building Services Division to negotiate between the parties for a resolution, and the Tribunal which can issue orders for services or payment and hear claims. In 2004 they issued Marketplace Guidelines to make insurance requirements more transparent to the user and allow builders to compare qualifying requirements, view forms and estimate insurance costs.

These steps have not addressed the underlying problems or made insurance easier to obtain. As stated by Mr. Richard Grellman when summarizing the outcomes of the program in the Inquiry into the NSW Home Warranty Insurance Scheme, “Although the intention may have been to protect the consumerthe effect has been to stifle building projects, raise costs and seriously reduce competition within the building industry.”

Queensland

In Queensland, the government underwrites the home warranty risk through a self-funding authority established under the Queensland Services Authority Act of 1991. According to their web site, the charter of the Building Authority Services (BSA) is to “regulate the building industry through the licensing of contractors, educate consumers about their rights and obligations, make contractors aware of their legal rights and responsibilities, handle disputes fairly and equitably, protect consumers against loss through insurance, implement and enforce legislature reforms and where necessary prosecute persons not complying with the law.” The Authority accomplishes this with a \$40 million dollar budget and about 250 employees.

Consolidating the home warranty insurance functions under one entity streamlines all processes, eliminates redundancy, and provides one stop vetting for builders. With both licensing and insurance functions linked through the same governing board, all builders who fulfill licensing requirements are automatically allowed to get mandatory home warranty insurance, and their license is proof of insurability so that building can commence without intervening steps. This allows construction to proceed in a timely manner, meeting timelines and reducing overall costs.

The financial fitness test is part of the licensing process and consists of simply providing proof of financial capacity to continue trade. It does not require financial guarantees or pledging assets for eligibility, making it easier for small firms and independent builders to qualify. Providing a larger pool of insured builders increases competition, keeps costs lower and allows less experience builders to learn on the job and perfect their skills and knowledge, insuring qualified contractors for the future.

Licensing criteria is reviewed annually, and builders found in default, or guilty of dangerous building practices, are banned from the industry for periods stretching from a year to a lifetime. The annual review also identifies “phoenix” companies, failed companies that resurrect with new identities. In 2005, fifty five individuals and 25 companies were banned from the industry for 5 years, and five individuals excluded for life. Self policing and removing the “bandits” from the system means reduced problems in the future and has helped renew consumer confidence in the trade.

Perhaps the most important aspect to the consumer is that Queensland insurance is “first resort” meaning that an owner has access to insurance if the builder fails to complete or rectify defective work, even if they are still in business and trading. It is also the only one that compensates for subsidence.

Quality control, frequent inspections and timely remediation are at the heart of the Queensland model, and it is working. Recent statistics show that although building and construction work insured by the BSA has increased by more than 50% in the past five years to a record \$7.4 billion annually, disputes have increased by only 6 per cent. Further, the number of disputes successfully resolved has dramatically improved from a low of 44% in 2000 to seven out of 10 in 2005. In 2003-2004 the authority paid out more than \$22 million to rectify defects. This was accomplished with the lowest premiums of any home warranty scheme which are capped at \$1280. And the Authority is profitable.

Phil Dwyer, the national president of the Builder’s Collective of Australia said when recommending the Queensland scheme “There is a model...that works perfectly and it’s got a 96 percent consumer approval rating and the builders are 100 percent happy with it.”

Ian Jennings, General Manager, states “BSA’s insurance cover is significantly cheaper and provides greater coverage than those offered by other states throughout the country. We punch above our weight when it comes to compliance and disputes... with the results over many years speaking for themselves.”

Home Warranty Insurance Plans Recommendations/Risks

Without a doubt, Queensland has the most highly praised and recommended home warranty insurance program, but such a scheme would take years to complete in the States. Therefore, here are several recommendations for intermediate steps that based on the evaluations of existing and proposed home warranty insurance programs. The

following suggestions are a compilation gleaned from a variety of sources, many of them overlapping. Please see Appendix A for a complete list of sources used in this paper.

Recommendation: The difficulty in obtaining sufficient insurance at an affordable price suggests that focus needs to be redirected from securing monetary awards for fixing problems to introducing more quality controls during approval and construction so as to avoid problems. The goal is to broaden and duplicate quality initiatives such as the National Housing Quality Certified Builder Program recently put in place by the NAHB. The following is a list of suggestions with associated risks that have surfaced in practice;

- Tighter licensing requirements that look at a builders' ability to finance construction and provide remedial work if necessary. *Risk: requires legislation and inspection; may screen out smaller, high quality builders if benchmarks set too high; limits competition*
- Require builders to meet educational benchmarks through industry training classes and on-the-job inspections. *Risk: builders will question the value of such classes which are currently available but rarely attended; it will take extra inspectors and special training to enforce*
- Require builders to be certified to build certain structures, i.e.; must demonstrate ability to build condos, high rises, residential housing etc. with a track record of success. *Risk: limits the consumer's ability to choose a builder; makes it difficult to be certified to build in a new "envelope"*
- Make builder credentials, track record, outstanding and settled suits, and financial records easily accessible to potential home builders/buyers on consumer sites so they can make informed decisions *Risk: consumers already have access to this type of information about doctors and other professions, but rarely use it; someone would need to monitor the information for accuracy and timeliness; developers/contractors with documented defects in their projects could make it impossible for homeowners to attain reasonable insurance or mortgage rates on their properties*
- Require more inspections during the construction process to identify concerns *Risk: mandated inspections, where they already exist, are not being met; more inspections require more inspectors, more training and more money; there is no funding for more inspection*

Recommendation: Require arbitration before a suit can be filed *Risk: arbitration requires a knowledgeable arbitrator; parties need to agree to abide by the decision of the arbitrator which may force them to forego constitutional rights to a trial by jury; decisions may be sealed from the public hiding severe defects*

Recommendation: Require independent inspections as well as appraisals for loans *Risks:* Depending on criteria lenders could raise requirements and loan rates, or may deny loans on questionable properties.

Recommendation: Purchase surety performance bonds that guarantee that a contractor will fulfill all contractual obligations in accordance with plans and qualifications. Such bonds typically cost between 1% and 2% of the contract price depending on the size of the project and the financial credit of the contractor. AIA has industry standard forms. *Risk: Homeowners and contractors must understand the contracts and should employ legal aid*

Recommendation: Adopt integrated practice to share risk and reward of outcomes, promote early collaboration among stakeholders and incorporate BIM supported designs to identify and solve problems during the construction phase and throughout the life cycle of the building. The result will be higher quality, cost effective, on-time delivery of projects reducing the need for litigation. *Risk: Integrated practice raises liability and contractual concerns that must be addressed before it becomes an industry standard.*

Impact on Architects

Architects must rely on contractors, developers and builders to fulfill the obligations of the contract and on the written guarantee that the work is in conformance. As Grant A. Simpson, FAIA, wrote in an August, 2006 article, [Absolute or Absolution](#) for the AIA Architect, “this obligation withstands all actions of the architect, including observations, inspections, submittal approvals, and payment certifications. This absolute power of the contractor to control and be responsible for the work is never shared, assigned or assumed by any other party.”

Risks continue to be significant barriers to change, and the complexity of existing laws make it difficult to enact broad legislation, however, they are certain, specific contract actions open to architects that can be applied to reduce liability. Here are several from a list of fifty found in Appendix A of [Risk Management Recommendations for Condominium Projects](#) by G. William Quatman, FAIA Esq.

1. Avoid inexperienced and risky developers.
2. Use an appropriate indemnity clause in contracts that protects the architect from claims caused by the owner, unit owners, HOA or contractor.
3. Place a time limit on claims against the architect from the owner, similar to the one that exists for the contractor.
4. Include a clause that limits the Architect’s liability to an established amount, such as the design fee or existing insurance coverage.
5. Include mediation and arbitration clauses in owner-architect agreements and subcontracts.
6. Document all construction inspections with digital photos and keep the photos for a minimum of 6 years.
7. Shorten the statute of limitations on statutory warranties whenever possible.

8. Retain AIA statute of limitations clauses intact.
9. Insist that key “project systems” be designed by a team of consultants chosen by the architect.
10. Include an express right of access to property for inspection.
11. Include a clause that requires an owner to hire a neutral, licensed architect to attest to merit for any lawsuits against design.

Appendix of Sources and Suggested Reading

Absolute or Absolution? By Grant A. Simpson, FAIA, AIA Architect August 8, 2006

A Basic Guide to Surety Bonds by John Curtin, AIA Architect May 2005

A New Home Warranty Means a Better Built Home National Home Warranty Programs LTD, Vancouver, British Columbia

Building Services Authority Protecting Consumers Statement by the Queensland BSA General Manager, Ian Jennings BSA Website March 2, 2005

Calderon's "Responsible Construction" Bill Passes Assembly on a 73-0 Vote and May Help Lower the Cost of Buying A Home Press Release June 3, 2005

California Contractors Win Liability Reform by Ned Barnett The Construction Zone 2005

California Assembly Bill 758 by Kenneth Miller and Chris G. Monahan Morgan, Miller, Blair December 21, 2005

Discussion Paper: Raising the Bar Homeowner Protection Office (British Columbia, Canada)

Governor Signs AB 758 Outlawing "Type 1" Indemnity for Residential Construction Defect Claims Cooper, White and Cooper LLP 2005

Hadd Report: Home Warranty Coverage 'Extremely Limited' by Broderick Perkins, Realty Times January 15, 2003

Home Warranty Insurance Choice Magazine (Australian Consumers Association) August 2004

Home Warranty Insurance New Offices of Fair Trading New South Wales, Australia May 2006

Housewrecked Consumer Reports January 2004

New Home Warranty Program of Manitoba Inc.

Queensland System is the Best in Australia BSA Website August 3, 2005

Queensland Building Services Authority Act 1991 (as amended by all amendments that commenced on or before September 30, 2005)

Report of the Condominium Act Study Committee (Washington State) January 2005

Response to the Report of the National Review of Homebuilders Warranty Insurance and Consumer Protection Ministerial Council on Consumer Affairs (Australia) November 2002

Submission to the New South Wales Government Minister of Commerce: Inquiry into the NSW Home Warranty Insurance Scheme by Mr. Richard Grellman Royal Institute of Architects July 2003

The Impact of Construction-Defect Litigation on Condominium Development CPRC Brief, Vol. 14. No. 7 October 2002

Understanding Home Warranties: Important Information for Homebuyers Homeowner Protection Office, Vancouver, BC

White Paper: Risk Management Ideas for Condominium Projects by G. William Quatman, FAIA Esq. AIA Trust April 2006