

Owners often bear costs of construction defects

Contractor's insurance is almost always inadequate and litigation costs can be problematic

Most owners rightfully expect that when they enter into a construction contract, the work will be properly performed, and if it is not, the contractor will be responsible for any defects. Unfortunately, when defects do occur, owners sometimes find themselves bearing a significant portion, if not all, of the resulting repair costs. There are a couple of reasons for this.



CONSTRUCTIVE ADVICE

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Part of the problem has to do with the limited scope of any contractor's insurance coverage. The standard commercial general liability (CGL) insurance policy that contractors are required to carry insures only the damages caused by any defective construction; it does not cover the costs of repairing the defects themselves. If, for example, a contractor is negligent in installing a roof, with the result that the roof leaks and the leaks in turn cause damage to the interior walls and floors, the contractor's CGL policy only covers the cost of repairing the damage to the walls and floors; it does not cover the costs of repairing the defective roof. The contractor in this example would be responsible for the roof repairs.

Although the owner is certainly entitled to be reimbursed by the contractor for the cost of repairing any defective construction, regardless of whether the owner is covered by insurance, the unfortunate reality is that oftentimes those repair costs exceed the contractor's ability to pay. It is not at all uncommon for small contractors to simply go out of business or file bankruptcy in the face of a significant liability claim. Indeed, in the course of much of the litigation over the last 10 years involving EIFS (a synthetic stucco product), numerous contractors and subcontractors went out of business as a result of liability claims.

Another problem facing owners is the cost of litigation. When construction defects result in significant damages, both the contractor and its insurance carrier are often motivated to dispute liability and litigate, sometimes even when their liability is fairly clear. In evaluating how far to proceed with litigation, an owner needs to evaluate both the litigation costs, which can be significant, and the risks of an unfavorable outcome. Insurance companies in particular are aware that when faced with these costs and risks, most owners will inevitably back down. As a consequence, the large majority of construction lawsuits are resolved through compromised settlements in which both sides bear some level of the costs. In most of the residential EIFS litigation, for example, homeowners often bore as much as 25 to 50 percent of the repair costs, which were oftentimes in the mid-six figures.

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Owners can take steps to limit their risks in the event of construction defects. On nearly all government contracts, the general contractor is required to post a performance bond, which provides a much broader form of protection to the owner than does an insurance policy. Although performance bonds are occasionally used in private projects, they are certainly not the norm. Although all Oregon contractors are required to post a bond with the Oregon Construction Contractors Board as a condition of being licensed, the bond requirement is only \$20,000 for a residential contractor's license and \$75,000 for a commercial contractor's license. Unfortunately, the costs of repairing any significant defects often far exceed these very minimal bond amounts.

Another option for the owner is to retain a contractor with the financial ability to take care of any construction defects that might occur. Unfortunately, this is not always feasible, as even mid- and large-sized companies can be incapable of responding to the significant repair costs that can often result from defective work.

It is becoming more common for owners on construction projects to retain an owner's representative or a construction manager to oversee the general contractor. Although it may seem unnecessary to retain someone to oversee the general contractor and ensure that the contractor is doing what it has been retained to do, many sophisticated owners now understand the benefits of this additional layer of oversight.

The owner of any construction project needs to be aware of the financial risks associated with a contractor's defective work. The contractor's insurance is almost always inadequate, many contractors are incapable of responding financially, and the litigation costs and risks for the owner can be problematic. In the majority of cases, the owner will bear some, if not a large portion, of the resulting costs. More often owners should consider retaining a construction manager and in some cases should consider requiring the general contractor to post a performance bond.

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