

Protecting Your Business

Risk Management

Use of Third-Party Warranties

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In the homebuilding industry, the term “Risk Management” traditionally involves some combination of insurance protection for the builder (general liability, builders risk, workers compensation, and similar insurances) and warranty protection for the buyer. This article discusses outsourcing the warranty coverage to a third-party warranty provider and answers the questions most frequently asked by builders about third-party warranties.

1. What is a third-party warranty?

In virtually every sale of a residential home, the homebuyer is provided with some type of warranty from the builder. In some instances, the builder provides the warranty and agrees to stand behind all warranty requirements in the future. However, in many instances, the builder elects to use a third-party warranty company to provide the warranty, offer coverage, and perform warranty work.

The decision to outsource the warranty coverage to a third party is done for a variety of reasons, including:

Cost (often it is much less expensive to use a third party who can spread the cost of warranty coverage over tens of thousands of homes, as opposed to the builder maintaining a warranty department and budgeting for the costs of future warranty expenses);

Convenience (using a third-party warranty provider frees up the builder to focus on core business areas such as construction and marketing, leaving warranty service to another business); and

Competitive pressure (many consumers prefer the security of a third-party warranty provider versus a builder who may not be around in the future to honor warranty provisions and cover claims.)

2. What is the difference between an “Express Warranty” and an “Implied Warranty?”

In the homebuilding industry, a warranty is the builder’s guarantee regarding:

The integrity of the home they’ve built,

Their responsibility for the repair or replacement of any defects that arise after closing.

Warranties fall into two categories, Express and Implied. An Implied Warranty is an unwritten promise made by the seller of a product to the buyer of that product. It is ‘implied’ because nothing needs to be written or specifically stated for the warranty to be applicable. The implied warranty is presumed by

law to be included in all new home sales and is legally required in each state. The most common implied warranty in the homebuilding industry is the Implied Warranty of Habitability.

An Express Warranty is a written or oral guarantee of performance and outlines the length and terms of the warranty coverage provided by the builder to the homebuyer. In many instances, builders elect to outsource their express warranty obligations and coverage to a third-party warranty provider.

Most third-party warranties describe in detail the following provisions:

- The performance standards that govern warranty coverage,
- Specific time limitations for coverage of workmanship, major systems, and structural damage defects, and
- Dispute resolution clauses (in the event a conflict arises between the builder, homeowner, and/or warranty provider).

3. Why would a builder need a third-party warranty when they carry Commercial General Liability and Builders Risk insurance?

In the homebuilding industry, express warranties, General Liability insurance, and Builders Risk insurance are the proverbial “three legs” of the three-legged stool of risk management. Having only one or two of the three legs leaves a builder exposed to construction defect claims.

General liability insurance protects against losses caused by negligent acts or omissions resulting in bodily injury and/or property damage to third parties. General liability insurance typically does not protect a builder against claims for construction defects brought by unhappy purchasers. Builders Risk insurance protects the builder against damages to the home while the home is under construction (before title passes to the buyer) and covers losses from risks such as fire, vandalism, and lightening. Like General Liability insurance, Builders Risk insurance will not protect a builder from claims that arise over shoddy or improper construction or workmanship.

A third-party express warranty provides a builder with significant protection against certain construction defect claims. A typical third-party warranty will clearly communicate the following:

- Exactly what is warranted (workmanship and materials, major systems such as plumbing and electrical, and structural coverage);
- How long each component of the home is warranted (i.e., structural warranties are usually for 10 years from the date of closing);

A third-party warranty will also contain language that provides third-party arbitration should a disagreement about coverage occur between the builder and the homeowner (this provides a solution to the problem without the time and expense of litigation). This language also limits the amount and types of recoverable damages.

4. Why would a builder need a third-party structural warranty when their structural engineer carries liability insurance?

A prudent structural engineer will carry professional liability insurance that provides coverage for any professional negligence or “malpractice” they commit. However, it is not sufficient to rely solely on the coverage (potentially) available from the structural engineer’s professional liability insurance. Structural defects in a home may arise from a number of causes unrelated to any negligence of the engineer, including failure of the builder to follow the engineer’s recommendations, poor workmanship, and/or material defects.

5. When does the third-party warranty coverage begin?

Unlike many other warranty companies, the third-party structural home warranty provided by StrucSure Home Warranty commences coverage on the day of closing and lasts for 10 years. Statistics show that most structural defects do not appear for three to five years after construction has been completed and can occur as long as 10 years after the buyer takes occupancy. For this reason, it is important to select a third-party vendor who offers coverage for as long as 10 years.

6. Does the home have to be “falling down” for the structural warranty to be applicable?

No. Warranty coverage becomes applicable once the home suffers from a “major structural defect” regardless of whether or not the home is actually “falling down.” A major structural defect is defined as actual physical damage to one or more of the load bearing elements of the home, caused by failure of such load bearing elements, which affects their load bearing functions to the extent that the home becomes unsafe, unsanitary, or otherwise unlivable. This commonly-used definition is identical to the definition of a major structural defect in the U.S. Department of Housing and Urban Development’s (HUD) regulations and is used by many businesses in the third-party warranty industry.

7. What is the significance of written performance standards in a third-party warranty?

By outsourcing warranty coverage to a third-party warranty provider, the builder, homeowner, and warranty provider are all contractually agreeing that the written third-party warranty will be the document that governs the warranty obligations of the builder and warranty company. It is very important that the warranty documents clearly define exactly what is warranted and when a warranted item qualifies for warranty coverage.

The written performance standards provided in the warranty define what is covered, when a covered item has a deficiency, and the necessary correction to remedy the deficiency. They also typically describe in detail quality standards for items such as site work, concrete flatwork, masonry, carpentry, thermal and moisture protection (insulation, siding, roofing), doors and windows, finishes (painting and wall coverings), specialties (i.e., fireplaces), cabinets and vanities, and mechanical/HVAC, plumbing, and electrical systems.

8. What should I look for in a third-party warranty company?

It is important to consider the following items when looking for a third-party warranty company:

How long has the company been in business?

Is their warranty backed by insurance? If so, is the insurance carrier rated by AM Best (a worldwide insurance rating agency), and what is their rating?

What is the degree and quality of underwriting performed by the warranty provider before they agree to warrant a home?

Is the warranty program FHA approved and HUD accepted?

Are the costs and coverage levels competitive?

Does the warranty contain specific performance standards?

Does the warranty include mandatory dispute resolution and arbitration language?

What is the warranty provider's history of paying claims?

What do the clients (both builders and homeowners) have to say about the warranty company?

9. What is the relevance of a third party warranty company being insurance-backed?

In order for a third-party warranty to be an effective component of a builder's risk management package and effectively insulate that builder from lawsuits, claims need to be thoroughly investigated and valid claims need to be paid.

An insurance-backed warranty provides a guarantee of sufficient funds to pay claims many years into the future. Since many potential homebuyers are concerned about the ability of the builder to honor warranty claims as long as 10 years after the home is sold, having an insurance-backed warranty provides peace of mind to the buyer about their coverage and helps the builder close more jobs.

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