



Are Construction Defect Claims Still Hammering the Industry?

CLRS – Chicago, IL

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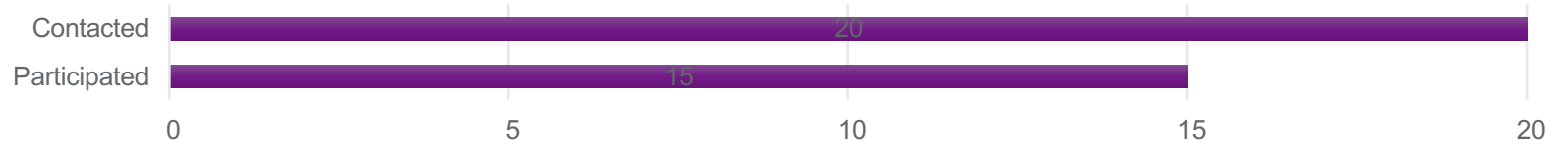
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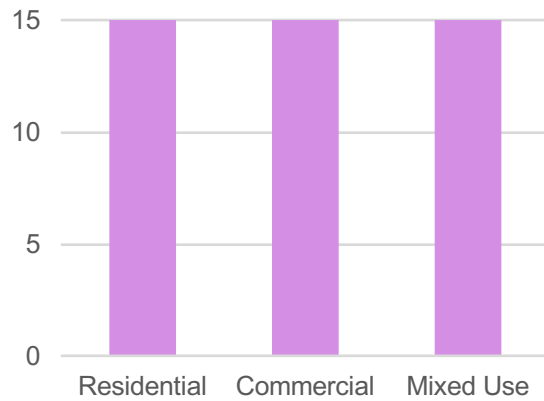
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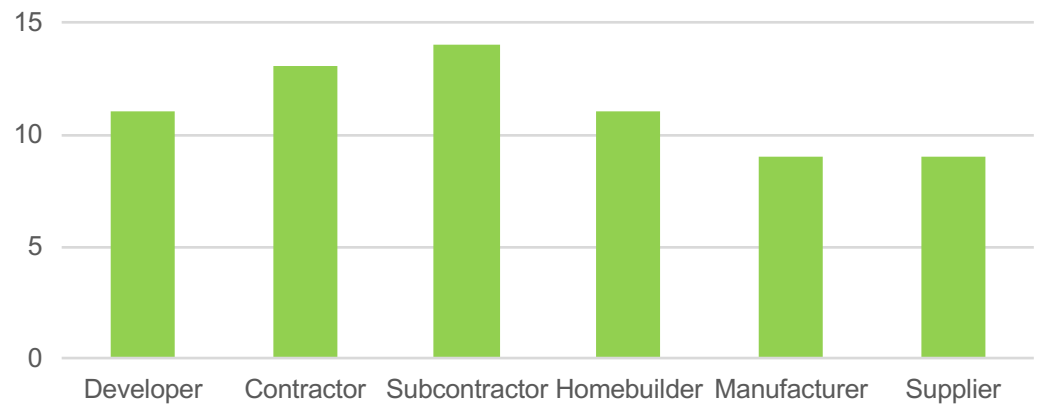
Companies



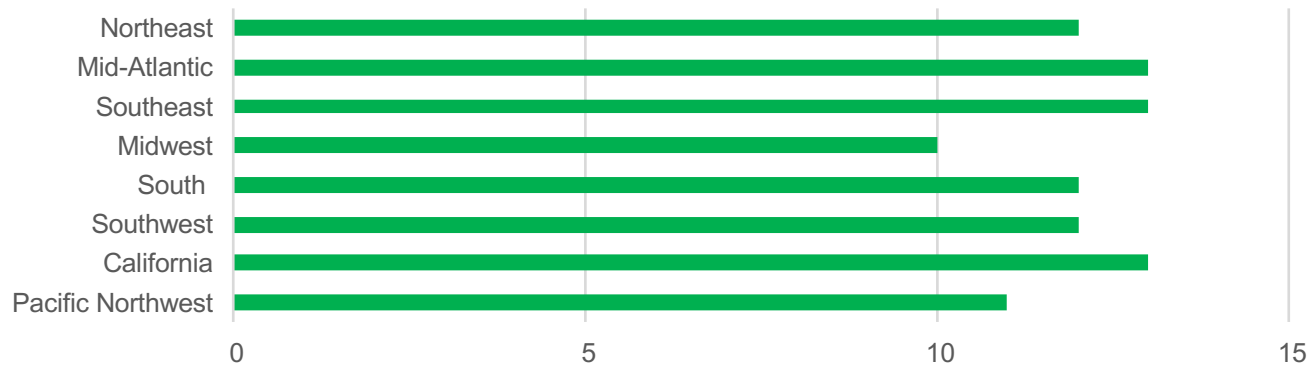
Construction Types



Risk Types



Geography



How do you identify construction defect claims?

- Most stated – “CD identifier determined by claim department”
- Definition examples
 - “Property damage resulting from defective workmanship in construction/modification of real property, >\$500,000 in Loss & ALAE”
 - Key words often include: Property damage resulting from “multiple defects and multiple defendants”; “multiple units involved”, “latent defects”, “additional insureds”, “multiple years exposed”, “reporting lag of 2+ years”, “handled by specific claims handling offices”
- Few identify between “residential” and “commercial” claims
 - Note distinction between contractor and claim (e.g., “80% of CD claims come from “residential” projects done by “commercial” contractors”)
- CD definitions can change over time as leadership changes or specialized claims unit introduced
- Definitions can vary
 - by TPA
 - between internal claims department and TPA

How do you identify construction defect claims?

- A few decent sized insurers currently undergoing initiative to flag CD claims
 - based on algorithm
 - working with claims departments to identify claims
 - currently working on open claims but will need to look at closed claims as well to complete triangle
- Actuarial concerns
 - Changing definitions
 - Incomplete definitions
 - Some CD claims not captured due to definitional issues (i.e., single family homes, only one year exposed)
 - Inconsistent definitions
 - Some CD claims exist in smaller books where not prominent and not identified
 - \$ limitations can cause problems
 - Claims can enter and leave the grouping
 - Are triangles restated or are the stable?
- Claim flags for CD not always perfect; look for late reported claims

Definition of Construction Defect

A construction defect is “the failure of the building or any building component to be erected in a reasonably workman-like manner or to perform in the manner intended by the manufacturer or reasonably expected by the buyer, which proximately causes damage to the structure.”

— CA State Jury Instructions

What is a construction defect claim?

Patent Defect

- Patent defects are defects detectable through reasonable inspection.
- An example of a patent defect is a wall that is moldy due to leaking pipes. This is something that would be expected to be readily detectable.
- In most jurisdictions, the Statute of Limitations for filing suit for patent defects is generally two to four years.

Latent Defect

- Latent defects are defects that are not detectable through reasonable inspection and are manifested over a period of time.
- An example of a latent defect is the pipes freezing in a house because the plumbing was not properly insulated. This is something that would be not be expected to be readily detectable.
- The time limit for presenting latent claims is often governed by a state's Statute of Repose, which begins running on the date that construction is completed. More time is allowed to submit a claim. The Statute of Repose is generally 6 to 10 years.

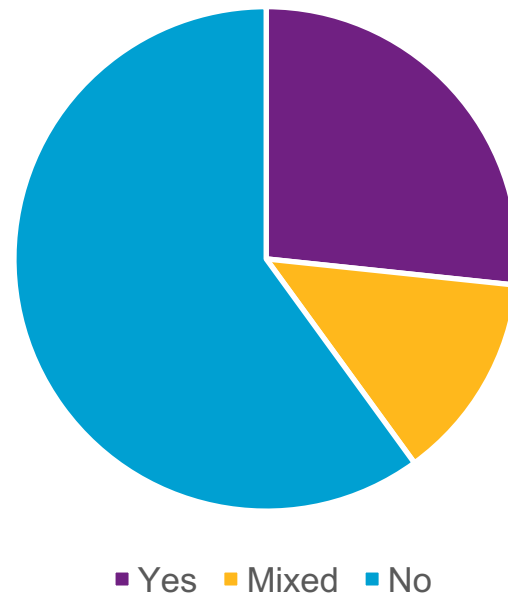
- The difference between a Statute of Repose and Statute of Limitations is that a Statute of Limitations is triggered by a known injury, while a Statute of Repose is triggered by the completion of an act (e.g., building date or completion date).

How is your construction defect data segmented?

CD Analyzed Separately?

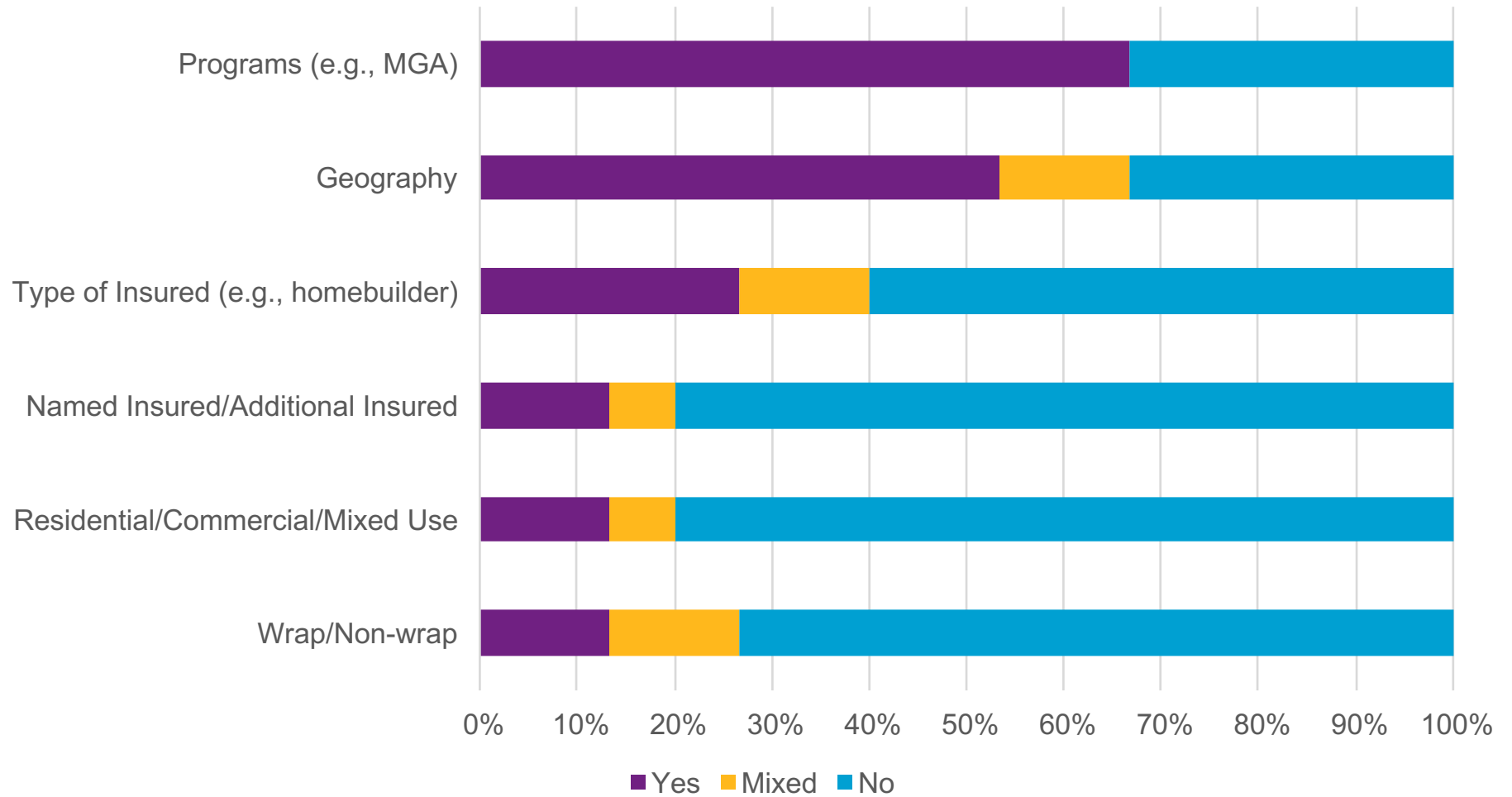


Comp. Ops and Prem/Ops Separated?



How is your construction defect data segmented?

Segmentation Breakdown



Construction Defect Data Segmentation

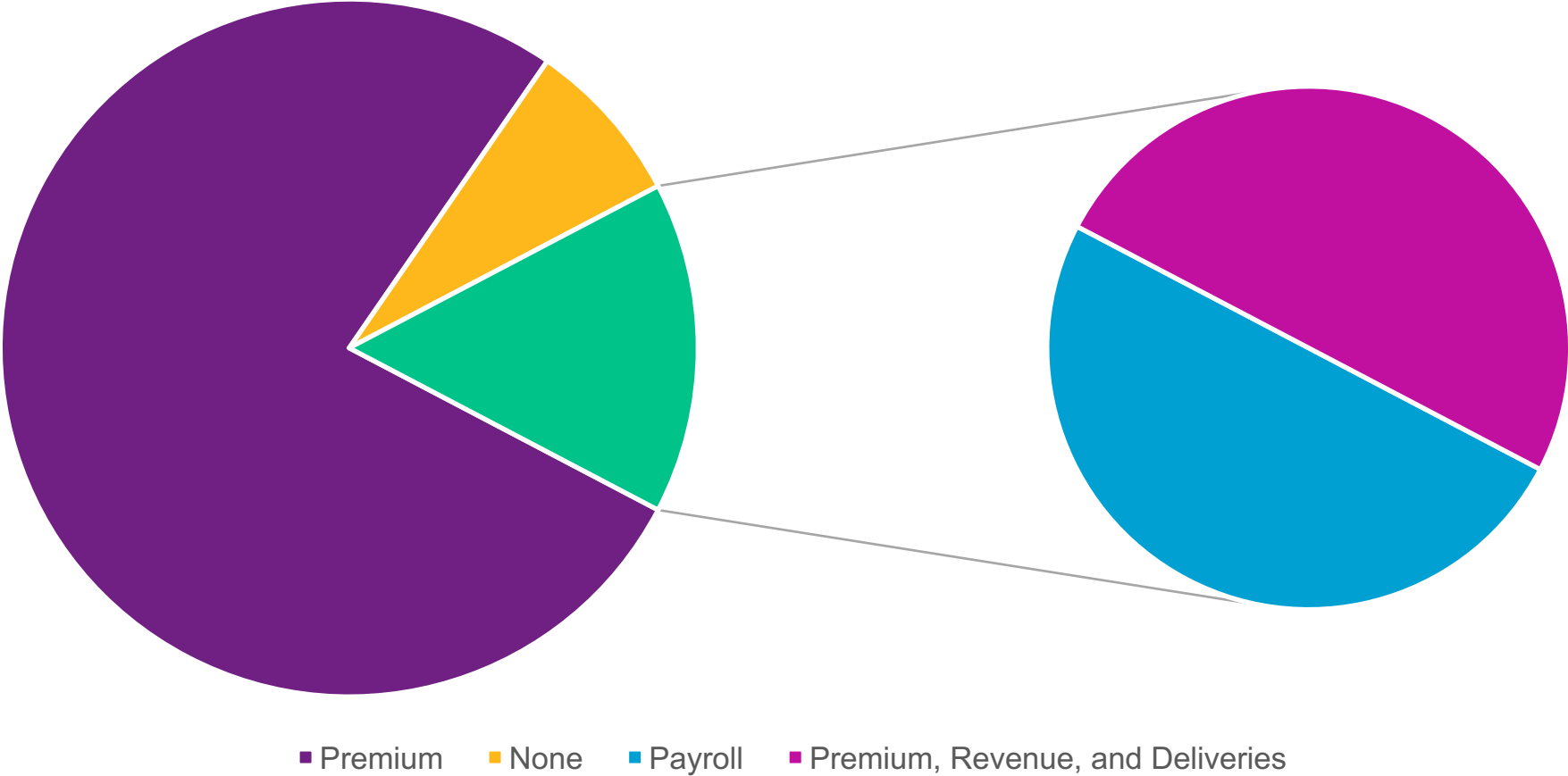
	#1	#2	#3	#4	#5	#6	#7	#8	#9	#10	#11	#12	#13	#14	#15
CD Analyzed Separately	Green	Green	Yellow	Yellow	Green	Green	Yellow	Yellow	Green	Red	Red	Green	Green	Red	Red
Comp. Ops vs. Prem/Ops	Green	Red	Green	Red	Red	Green	Yellow	Red	Red	Yellow	Red	Green	Red	Red	Red
Programs (e.g., MGA)	Green	Green	Green	Green	Green	Red	Green	Green	Green	Green	Green	Red	Red	Red	Red
Geography	Green	Green	Green	Green	Green	Green	Red	Red	Yellow	Red	Green	Red	Yellow	Green	Red
Type of Insured	Green	Yellow	Yellow	Green	Green	Red	Red	Red	Red	Green	Red	Red	Red	Red	Red
Named Insured / Addl Insured	Red	Green	Red	Green	Red	Red	Red	Yellow	Red	Red	Red	Red	Red	Red	Red
Residential / Commercial	Red	Red	Red	Red	Red	Green	Yellow	Green	Red	Red	Red	Red	Red	Red	Red
Wrap / Non-Wrap	Yellow	Green	Green	Red	Red	Red	Yellow	Red	Red	Red	Red	Red	Red	Red	Red

Data Segmentation Observations & Concerns

- Observations
 - Geographical splits
 - “High risk” states (e.g., CA, NV, TX, CO, etc.)
 - Labor law issues (e.g., NY)
 - Segmentation granularity not always proportional to business volume
 - Segmentations often done only by proxy
 - Using AY/PY as a proxy for residential/commercial
 - Using program as a proxy for geography
 - Using program/division as a proxy for type of insured
 - Wrap/Non-wrap not an issue for most participants – rarely segmented
- Concerns
 - Pricing team analyzes CD at higher granularity than reserving team
 - Inability to distinguish named insureds vs. additional insureds
 - Low CD loss volume did not enable granular segmentation
 - CD only broken out on primary business and not XS

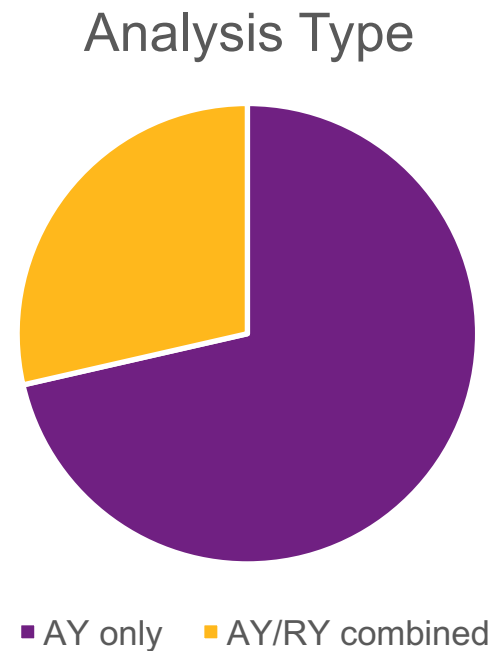
Which exposure bases were used?

Exposure Base



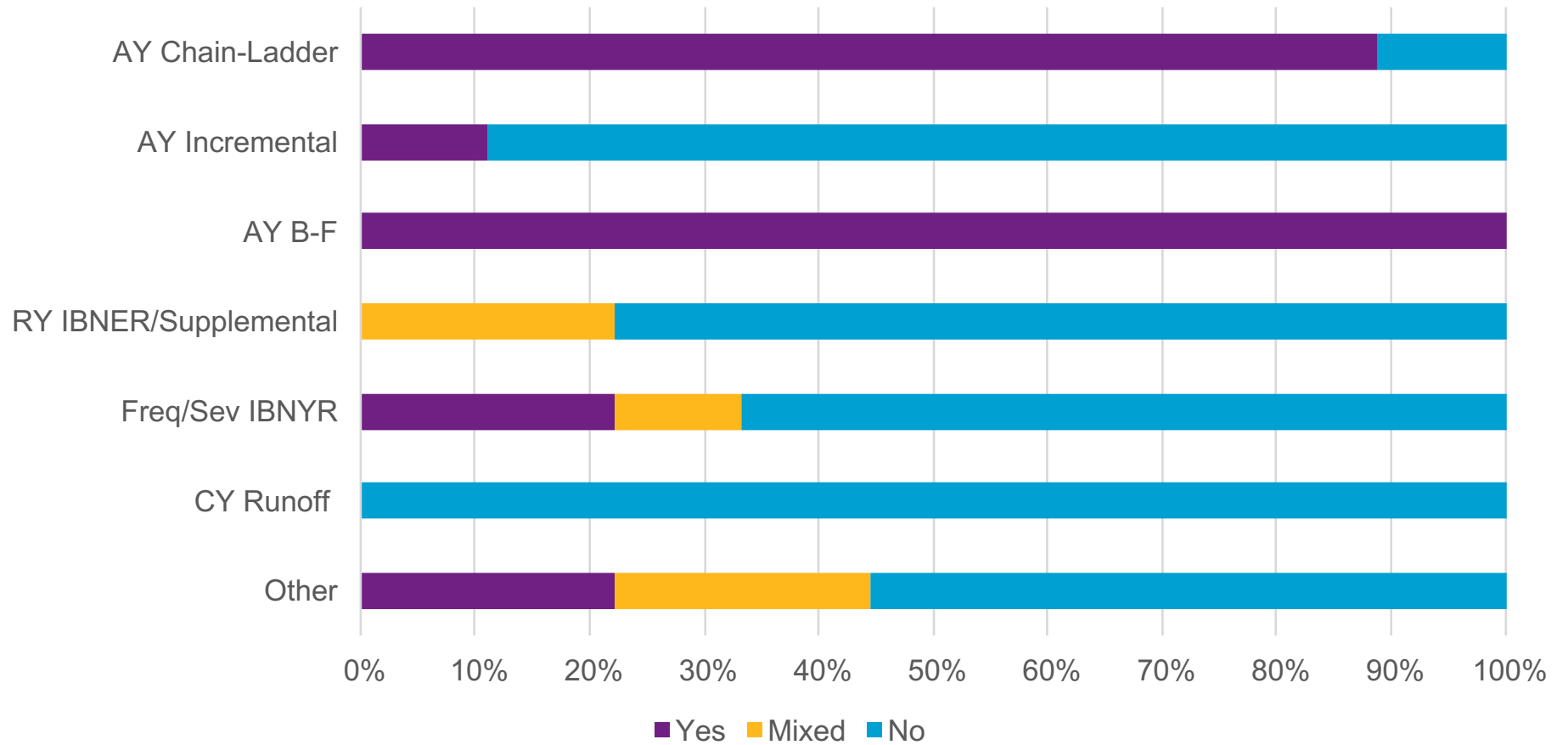
Is the CD analysis performed on a ...?

- Coverage basis
 - All respondents wrote occurrence-based policies almost exclusively
 - Some occasional reporting restrictions / sunset provisions
- Analysis basis
 - Most used traditional AY methodology
 - Some have switched from an AY IBNYR/RY IBNER approach to an AY-only approach due to declining loss volume



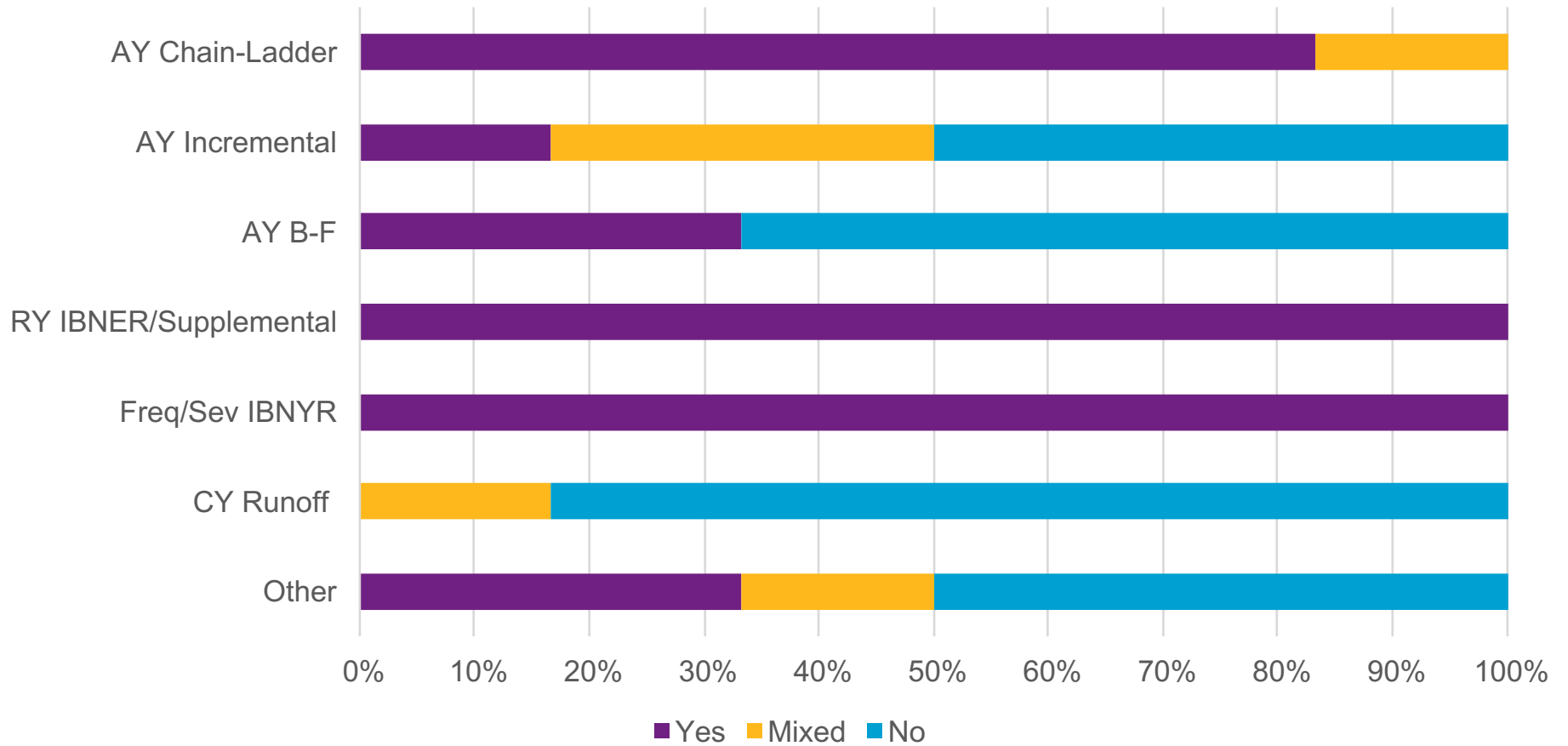
What projection methods are used in your analysis?

Development Methods Used – AY Respondents



What projection methods are used in your analysis?

Development Methods Used – AY/RV Respondents



Development Methods

- Many methods used only for diagnostic purposes
- “Other” method examples
 - Paid-to-paid method on ALAE
 - Claim-based GLM methods
 - RY-based exposure earning
 - Vary severity by evaluation age
- Alternative segmentations
 - Separation by claim size

WTW Preferred Methodology

Combination of

Report Year Loss Development

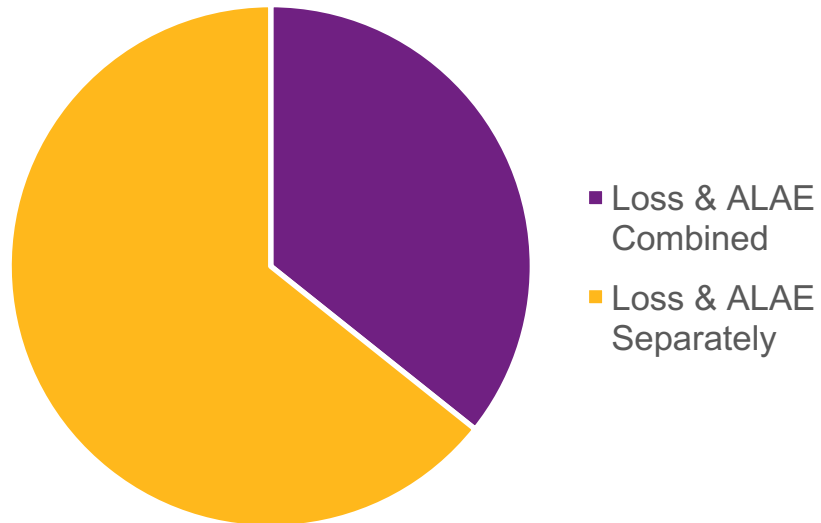
Frequency/Severity Method for “Pure” IBNR

$$\text{Ultimate Loss \& ALAE} = \left(\begin{array}{c} \text{Reported} \\ \text{Loss \&} \\ \text{ALAE} \end{array} \right) + \left(\begin{array}{c} \text{RY} \\ \text{Supplemental} \\ \text{Reserve} \end{array} \right) + \left(\begin{array}{c} \text{IBNR} \\ \text{Reserve} \end{array} \right)$$

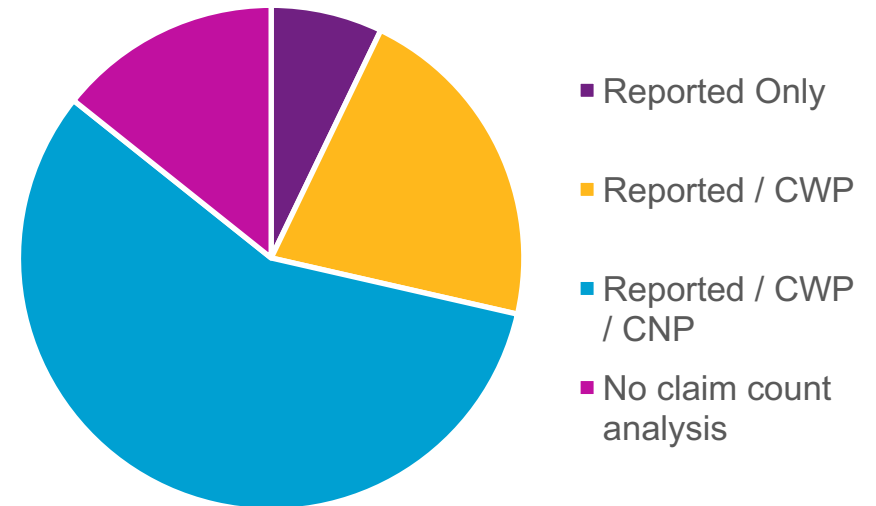
$$\text{Where IBNR Reserve} = \left(\begin{array}{c} \text{IBNR} \\ \text{Claim} \\ \text{Counts} \end{array} \right) \times \left(\begin{array}{c} \text{CWP} \\ \text{Ratio} \end{array} \right) \times \left(\begin{array}{c} \text{CWP} \\ \text{Severity} \end{array} \right)$$

How is the loss and claim count data segmented?

Loss Data



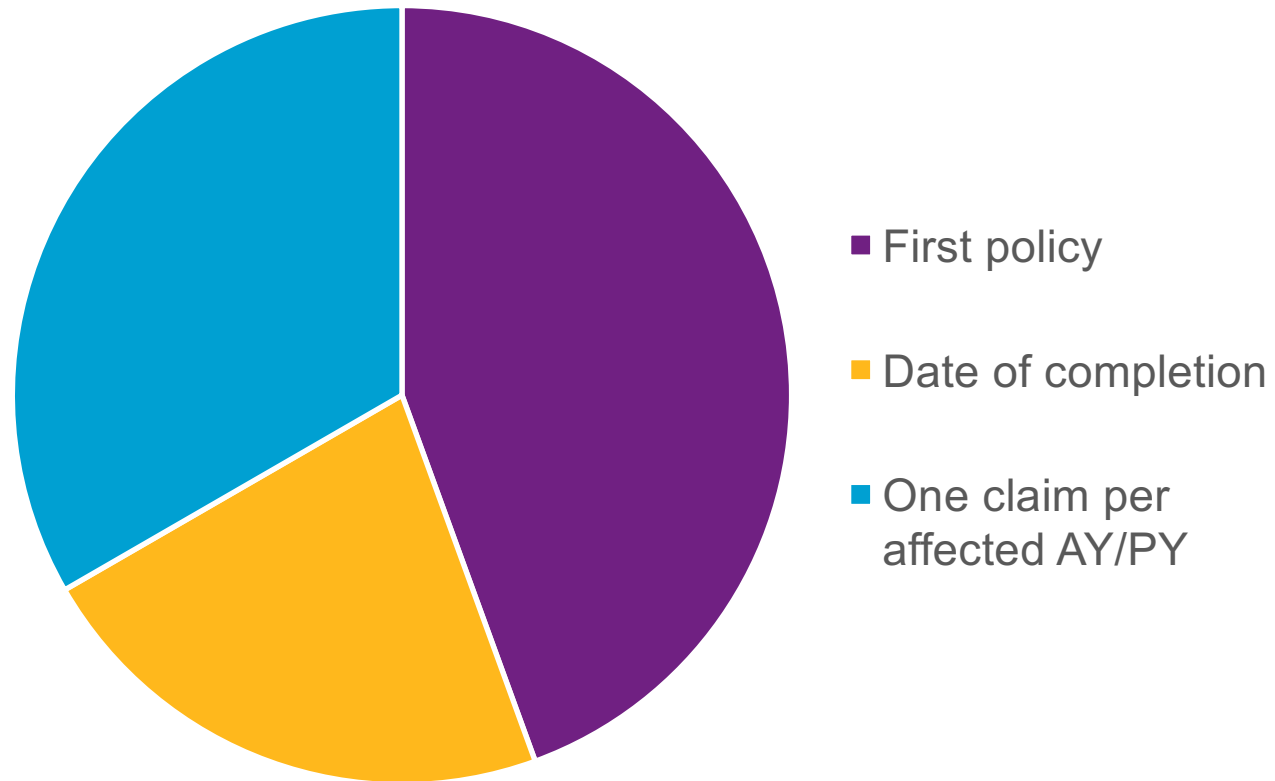
Count Data



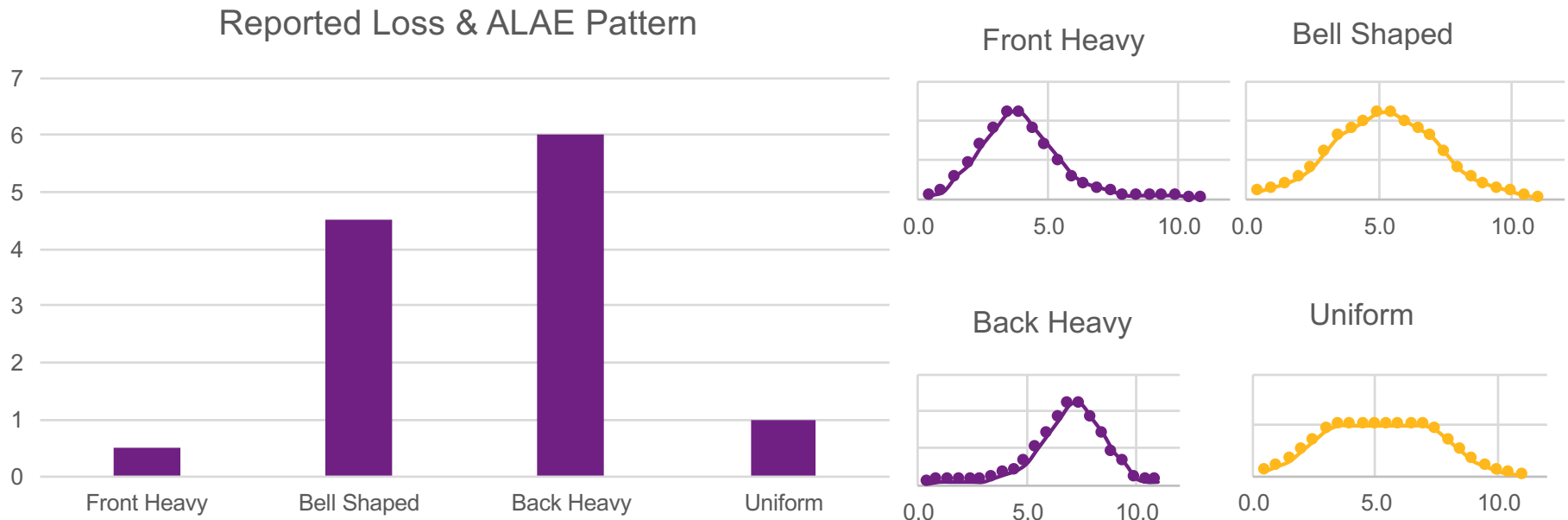
Actuarial Data Segmentation Issues

- Closed claim definitions vary considerably
 - Closed with any payment
 - Closed with indemnity payment
 - Closed with expense only
 - Closed with no payment
- Some respondents exclude CNP claims from their analysis

How are claims coded to accident year / policy year?

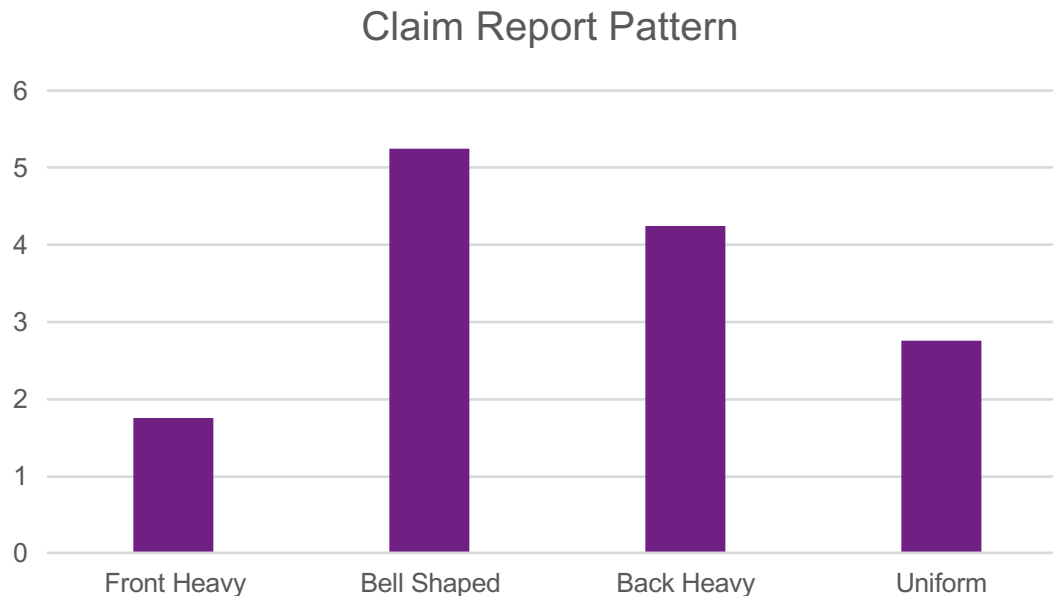


How would you describe reported loss and ALAE patterns?



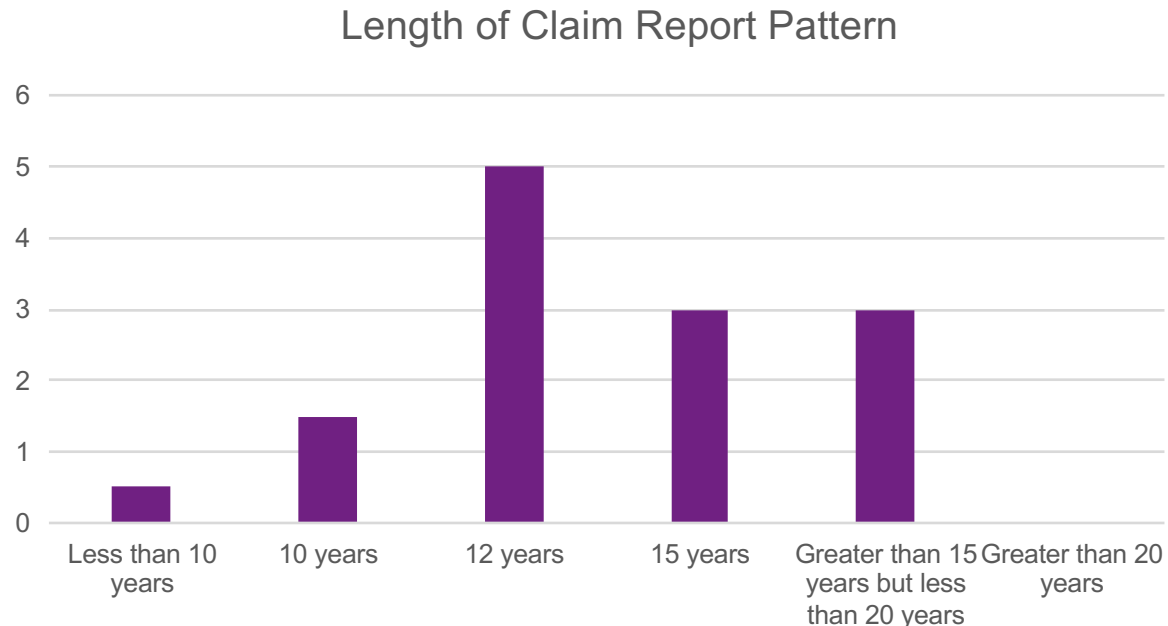
- Loss and exposures included can influence pattern
 - Possibly bimodal shaped if prem/ops (or Other GL) included; above \$ thresholds
 - Patterns can be influenced by end of statutes of repose
- Large claims may take years to be reported and longer to develop
- Slowing by policy exclusions, selective underwriting, business run-off?

How would you describe your claim reporting patterns?



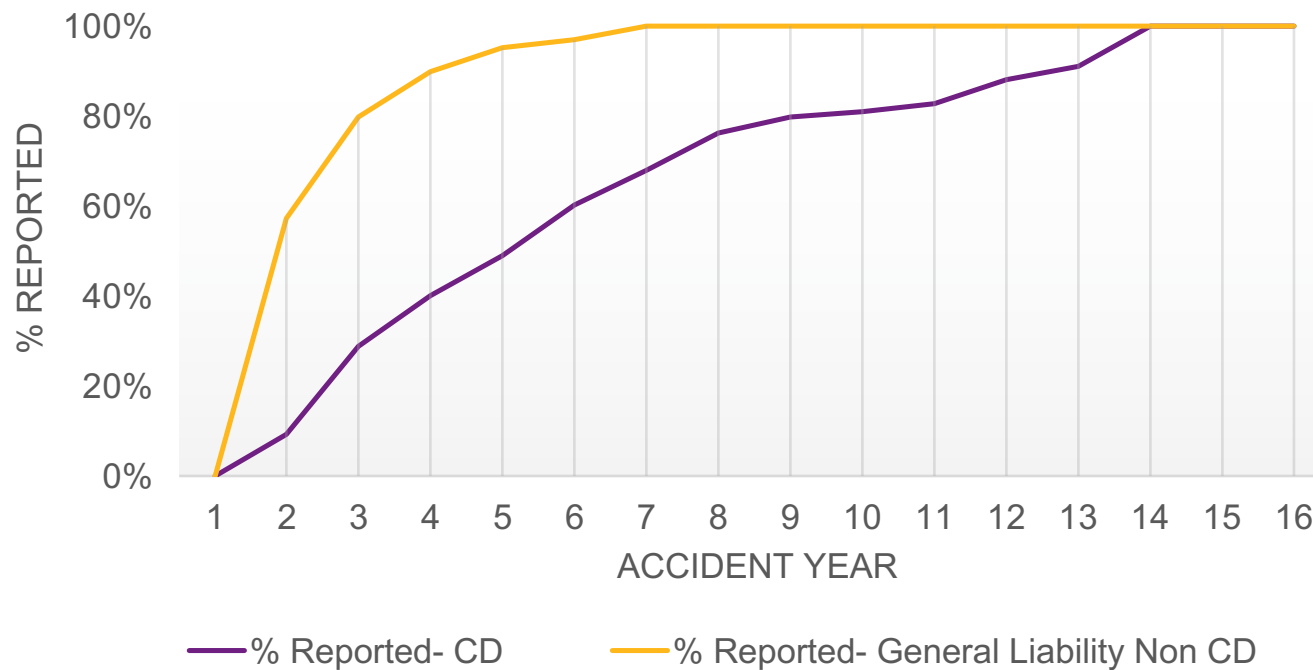
- Claims reported first before case reserving and settlement
- Many mixed answers, describing the pattern as a “flat bell” or trapezoidal.
- Claims handling and better identification of CD claims has accelerated the patterns for some participants.
- Some concerns with increasing Additional Insured (AI) leading to later reporting.

How long do claim reporting patterns go? Do you have different assumptions for Closed with Payment?



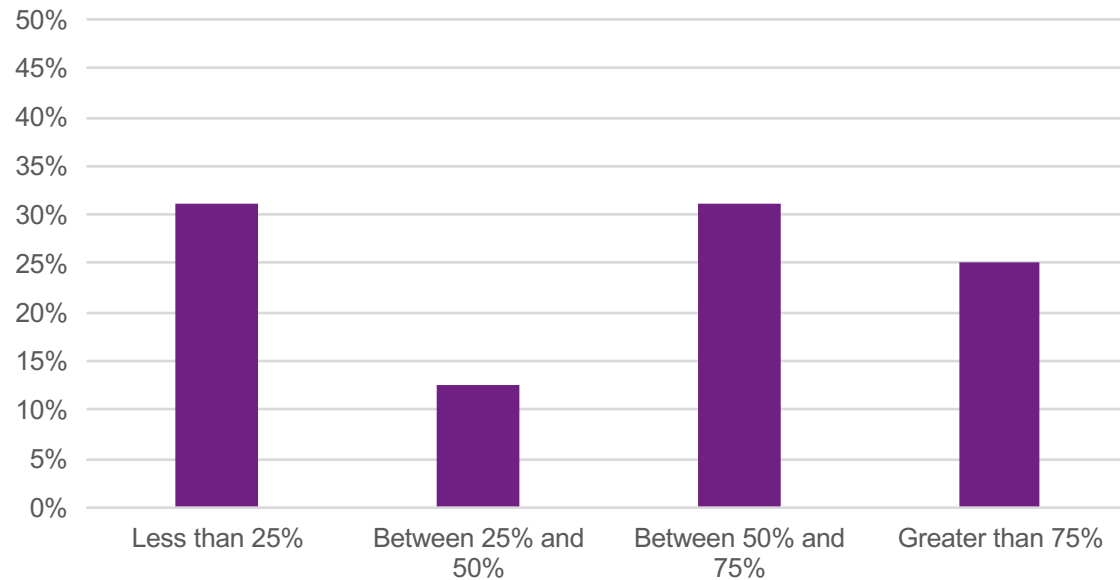
- Some not in the business long enough to know
- After 12 years, many claims are closed no pay (CNP). Statute influenced.
 - Can cause an anomaly of reported counts longer than reported loss.
- Traditional GL ends by years seven or eight years
- Definition of start date may influence length (start or end of a project or policy)

Traditional GL v. Construction Defect Reported Count Development



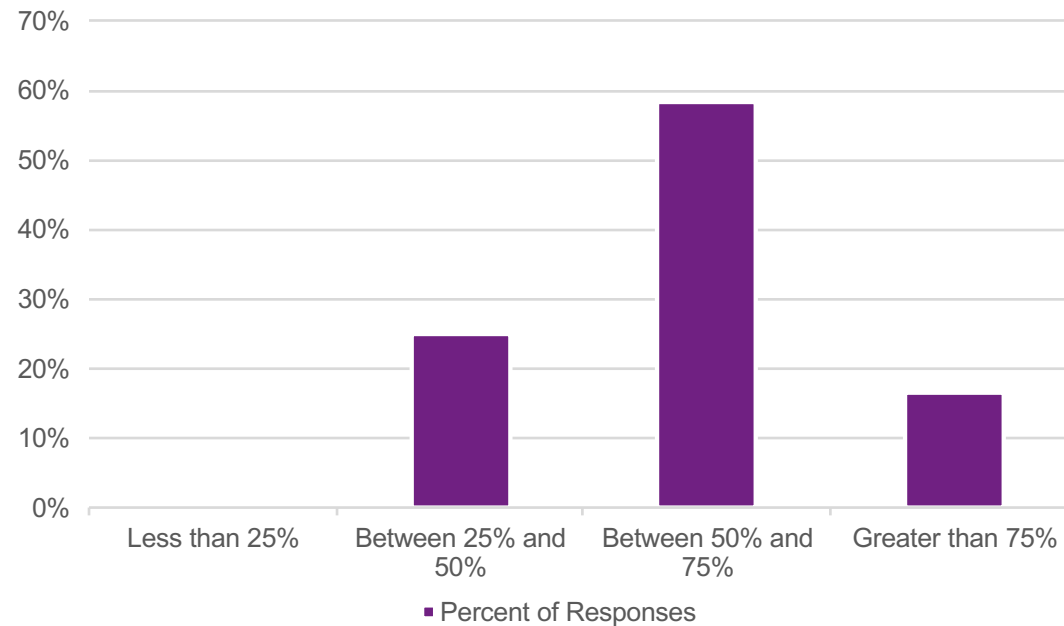
- The vast majority of non-construction defect claims are reported by five years
- Construction defect claims have a significantly slower development pattern
- Reported loss & ALAE (defense costs) can take substantially longer to development

Approximately what percentage of your construction defect claims are Closed with No Payment? How has it changed over time?



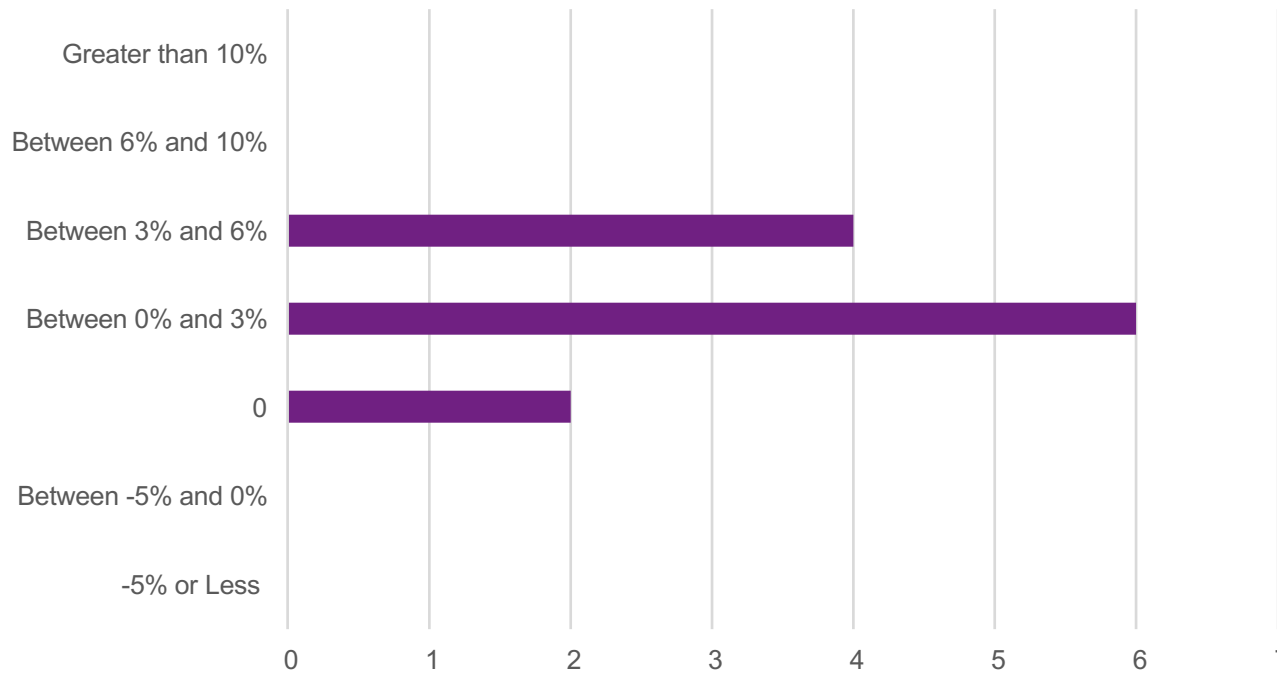
- Many claims have at least some ALAE – especially if TPA used
- Patterns can vary based on the age of claims
 - Which varied by participant for length of time in the business
- One respondent thought AI was less likely to close with payment.

Approximately what percentage of your construction defect claims are Closed with No Indemnity Payment? How has it changed over time?



- Most thought at least 50%, given any payment.
- Additional Insured reports may be even higher CNIP
- Changes due to new exclusions?

What severity trend rate, if any, are you applying to on-level claims?



- 3% is a common answer (split above); Standard ISO/CPI?
- New books of business may need higher
 - Prior severity trends possibly off-set by improvements in quality build and training. Now with labor shortages, where are we? Did builders keep the trained contractors or the less experienced?
- “Additional Insured claims may need a separate, higher trend”

Changes in Frequency, Severity and Pure Premiums

- Economy driven? Increase in CNP?
 - Historic shotgun approach – get dollars where you can
 - How will recent surge in building and labor shortages affect claims?
- “(Selective) underwriting and policy exclusions have removed unfavorable policyholders.”
 - The underlying exposures change making a “trend” difficult to discern
 - Experience may look favorable after exiting residential California, adjusting policies – e.g. excluding landscaping or excavating from coverage
- Will frequency decline given expansion of anti-indemnity statutes and tightening of policy language of insurers? Who’s on the hook?
 - Fewer parties involved but increased payout?
- Similarly, severity seemed flat 2006 – 2010 but volatile or unclear subsequent
- The highest severity comes from mounting defense costs
- Pure premiums seem uncertain with changing mix of business and state/regional differences

Please identify if any claims are excluded or handled differently (e.g., EIFS, CDW, yellow brass, etc.).

- Most participants did not have these, and they were frequently handled by another department/line
 - For example, it would go through mass tort actuarial or corporate actuarial
- In our experience, through large severity or high frequency, certain claims need to be removed due to distorting information.
 - Need to think about “on-going” exposures
 - Worthwhile to look at sizes of loss (or causes of loss – like AI) and to look for anomalies.
- Lawyers love “system defects” where a uniform product can be extrapolated to many units and areas.
 - Prior claims of one type may influenced choice to settle
 - Not as many recently...
- Green construction trend? Effects on outer envelope or any water intrusions?

Possible Data Segmentation

Category	Considerations
Geography	<p>Standard practice is to analyze California separately due to the mature and unique legal environment for Construction Defect claims</p> <p>Based on size of exposure or claim experience suggest grouping other problematic states (e.g., WA, OR, NV, AZ, NM, CO, TX, LA, FL)</p>
Exposure-Driven Segmentations	<p>In some circumstances, companies might also segment the data by an additional segment or two reflecting programs with such characteristics as:</p> <ul style="list-style-type: none">• Residential vs commercial• Homebuilders, general contractors, subcontractors• Primary vs excess layers• Wraps vs non-wraps
Loss-Driven Segmentations	<p>The most common loss driven segmentations might be:</p> <ul style="list-style-type: none">• Loss vs. ALAE• Named insured vs Additional insured• Accepted vs. denied claims <p>Additionally companies may separate out specific large claims or product liability type claims such as EIFS or Chinese drywall</p>

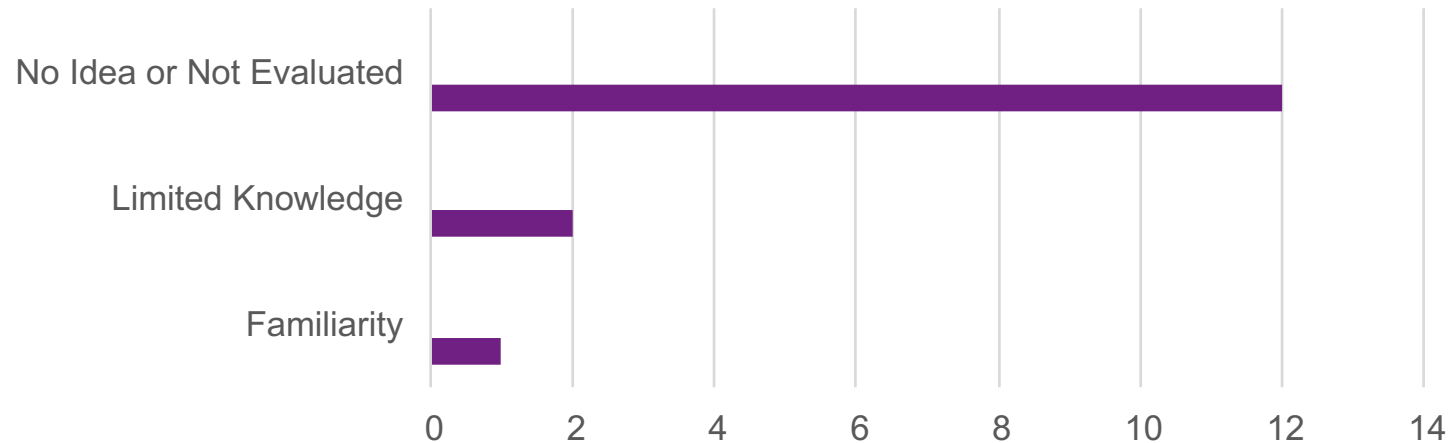
Notice And Opportunity To Repair (NOR) Statutes

- Right to repair statutes impose procedural requirements and a timeline for managing construction defects prior to filing a lawsuit
- Some states require a procedure opt-in by the builder in the purchase contract at the outset of a project
- Once a defect is discovered, the owner is required to notify the builder within a certain time period prior to filing a lawsuit
- The builder then has deadlines to respond, conduct an investigation, notify subcontractors and then either to repair, settle or deny a claim
- Statutes may be limited as to type of construction or defects

Are NOR Statutes effective?

- Effectiveness depends upon the perspective from which they are being evaluated
- More complaints about NOR Statutes than there are compliments
 - **Short time frames** for builders to respond, leaving little time for inspections and insurance companies to respond, especially if construction is older and documentation hard to find
 - Reasonable detail in identifying issues can lead to vague and **frustrating defect notifications**
 - **Inability to obtain a release for repairs made** – hampers a builder’s incentive to consider making repairs
 - Because litigation has not begun, some states not consider a “suit” so **not obligating insurer to defend and indemnify**
 - **Handling of attorney’s fees**
 - Once attorneys involved, **NOR laws are ineffective in reducing litigation**
 - Because states allow homeowner to reject builder’s offer to repair, statutes can be an **additional hurdle** in the litigation process

Describe how your losses have been affected by NOR statutes?



- Questions to consider on a state basis
 - Effective statute?
 - Effect on pattern?
 - Are payments covered by insurance? Warranty or insurance claim?
 - Effect on severity?
 - Effects on SIRs?

Additional Insured (“AI”) Endorsements

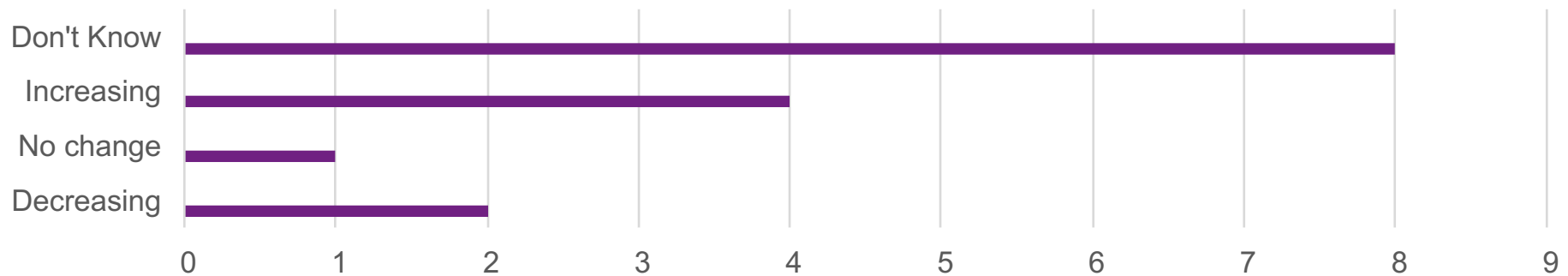
- An AI endorsement amends subcontractor’s policy so that it covers the general contractor for work performed on the contractor’s behalf by the sub
- With additional insured status, general contractors look to the subcontractor’s insurer for defense and indemnification. General contractors want to be protected financially from lawsuits resulting from the subcontractors’ work
- Residential CD claims and suits often name numerous parties as defendants, including: general contractors, subcontractors, manufacturers of building components and material distributors
- Allocation of defense costs: since each policy is obligated to answer, most courts require cost-sharing by equal shares; some courts allow sharing on a pro-rata basis
- Dozens of different AI endorsements and schedules
 - 2004 — ISO revised standard additional insured endorsements to require at least some fault on the part of the NAMED insured for the additional insured’s coverage to apply: “caused, in whole or in part, by” the named insured
 - General movement by insurers to tightening AI coverage

California Construction Indemnity Changes

- Historically, for both residential and commercial projects, California owners and builders could pass liability to downstream parties - the general contractor, subcontractors, and suppliers via Type 1 indemnity clauses. Type 1 clauses afforded significant protection for indemnitees
- AB 2738 (effective 2009): owners, developers, and general contractors could no longer obtain Type 1 indemnity from subcontractors on residential projects as to construction defect claims. Instead, subcontractors' construction defect indemnity obligations were limited to claims arising out of the subcontractors' respective scopes of work
- SB 474 (effective 1/11/13) put further limitations on contractual indemnities. Commercial projects are now included
- As a consequence, commercial owners will use more owner controlled insurance programs (OCIPs) and commercial contractors will use more contractor controlled insurance programs (CCIPs).
- SB 474 may result in more disputes and litigation since the legislation bars indemnification of an owner to the extent of the active negligence of the owner.
- What qualifies as the owner's "active negligence"?

Describe below the prevalence and impact of additional insured related claims observed in your losses? Have there been any shifts over time?

Have There Been Shifts In AI Losses Over Time?



- Only 2 companies claimed to be analyzing AI losses separately
- Comments
 - “AI exclusions being eroded (ProBuilders court case (2016 CA))”
 - “More (sub)contractors getting dragged in”
 - “More focus on u/w form modifications”
 - “We were late to restrict”
 - “Logic of coding AI changed over time so difficult to evaluate”
 - “Large homebuilders getting more aggressive in pursuing AI”

Are there any court cases or class action lawsuits that concern you?

- ProBuilders case in CA (2015 or 2016) – eroding of AI?
- Crawford claims – direct actions against subcontractors
- Court cases dealing with risk transfer
- Reductions in indemnity statutes
- “Big court case in NJ, where NJ could be turning into FL”.
 - Cypress Point Condominium Assoc v. Adria Towers? – “occurrence” definition
- Loy and Gasket agreements
 - primary insurers can settle for less than their limits but can still trigger the excess layer. Helps their primary policies but hurts their excess book. Applies to direct action states (LA and WI, at least) and is not specific to CD
- Cases affecting re-openings of closed claims for issues relating to previous denials of coverage

Are there any states or segments of your book that concern you more than before?

Any homebuilders

Any residential construction

CA, WA, AZ, TX, FL, SC, VA, MD, PA, NY

FL stucco claims

Apartments in WA

CA CD lawyers leaving for other states

Any new state considering CD as an "occurrence"

New York labor laws

Wrap policies (especially for high rises)

Public entity buildings in TX

Individual single family home claims in Pacific Northwest



Plumbers, roofers, glaziers/window installers, tilers, landscaping

Do you believe CD claims are still hammering the industry?



Yes

- “More than expected, both in older years and newer years; seeing claims in places that weren’t seen before”
- “Used to be a sledgehammer but now a carpenter hammer; mitigated by exclusions, awareness and actions”
- “Still getting a high number or reported claims, especially high severity ones”
- “AI keeps shifting claims even when no attributable negligence”
- “We were hammered and we ran away. We stopped writing!”
- “New carriers are getting hit especially; gift that keeps giving”

No

- “This has been around long enough; people should be aware of it”

Undecided

- “Difficult to evaluate for the whole industry”
- “Still hammering but don’t know if more than expected “

In Summary

- Level of sophistication not correlated with size, seemed like mid-tiered companies with greater CD exposure most sophisticated
- Surprised by use of traditional LDF and BF methods that mask many of the challenges with CD claims
- Lack of understanding of construction policies/environment
 - E.g., terms & conditions, exclusions, trends, legislative issues
 - Actuaries rotated through a reserving line of business often don't have the history of the issues affecting CD claims

“Those who cannot remember the past are condemned to repeat it.”

.....George Santayana, *The Life of Reason*, 1906

- Educational opportunities
 - Mealey's CDI and CD Reports
 - Actuaries/underwriters/claims staff should attend IRMI's Construction Risk Conference
 - November 6-9, Orlando FL
 - IRMI's Construction Insurance Risk Specialist (CRIS) designation

Mealey's Litigation Report

Construction Defects Insurance

MEALEY'S® LITIGATION REPORT

Construction Defects Insurance

July 2016 Volume 13, Issue #6

Insured's Defective Work Is An 'Occurrence' Under CGL Policy, Iowa High Court Says

DES MOINES, Iowa — An insured's faulty work may constitute an "occurrence" under an excess commercial general liability insurance policy, a majority of the Iowa Supreme Court affirmed June 10, also finding that a trial court did not err in instructing a jury to determine whether damages arose due to an "accident" constituting an "occurrence" by considering the insured's viewpoint and what it intended or should reasonably have expected. **SEE PAGE 4.**

Ohio Appeals Panel Says Alleged Damages Fall Outside Insurance Policy

CHILLICOTHE, Ohio — Homeowners' damages from the construction of a mobile home began before a policy period and, thus, are not covered under an insurance policy, an Ohio appeals panel affirmed June 16, finding that an insurer had no duty to defend or indemnify an insured. **SEE PAGE 5.**

Insurer Has Duty To Defend Water Damage Claims, Judge Finds

CHICAGO — An insurer has a duty to defend claims for mold growth and water damage due to an insured's defective construction, an Illinois federal judge ruled June 8, also finding that "contractual liability" and "damage to property" exclusions do not apply. **SEE PAGE 10.**

Texas High Court Refuses To Rehear Coverage Suit Over Defective Flanges

AUSTIN, Texas — The Texas Supreme Court denied two motions to rehear a commercial general liability coverage dispute arising from faulty flanges that resulted in an underlying \$6,345,824 settlement against the insured, according to its June 17 orders pronounced list. **SEE PAGE 11.**

Judge Says Insurer Has No Duty To Defend, Indemnify Breach Of Contract Claims

HONOLULU — A commercial general liability insurer has no duty to defend or indemnify underlying breach of contract claims, a Hawaii federal judge ruled June 7, also finding that the insurer did not breach the covenant of good faith and fair dealing by initially denying insureds' tender. **SEE PAGE 14.**

Federal Magistrate Judge Dismisses Insurer's Fraud Indemnity Counterclaims

PITTSBURGH — A Pennsylvania federal magistrate judge on June 3 dismissed fraud and indemnification counterclaims filed by an insurer in a lawsuit over a contract payment dispute between a town's wastewater authority and the insurer. **SEE PAGE 17.**

Panel Finds Ambiguity In Excess Insurance Policy's Faulty Work Exclusion

PHOENIX — An excess insurance policy's faulty workmanship exclusion is ambiguous as to whether an insured's work was "put to its intended use," an Arizona appeals panel ruled June 2, vacating a trial judge's grant of summary judgment to the insurer regarding coverage for construction defect claims. **SEE PAGE 18.**

Federal Judge Says Stay, Not Dismissal, Of Insurer's Suit Is Appropriate

PROVIDENCE, R.I. — A Rhode Island federal judge on June 10 stayed an insurer's suit seeking a declaration that its policy's pollution exclusion bars coverage for an oil spill because the insurer's suit was filed before the insured's state court suit, which also seeks a coverage declaration for the oil spill. **SEE PAGE 19.**

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