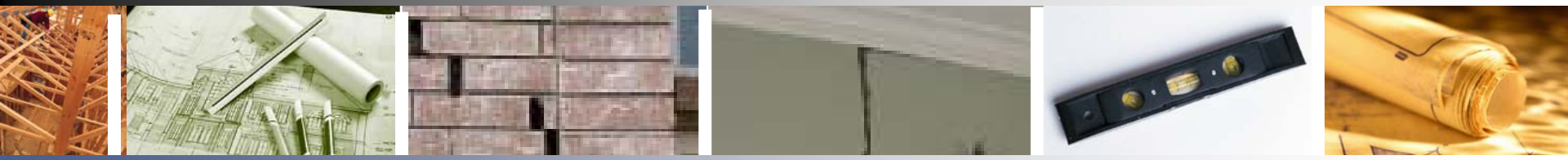
COM-9: Construction Defect Claims and Contractors General Liability



Casualty Actuarial Society
Ratemaking Seminar – March 11, 2004

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California Population Growth and Housing Supply Shortage

- In the late 70s through early 90s, California experienced unprecedented population and housing growth
- CA population growth was twice the US population growth rate in many periods
- Demand for housing exceeded supply
- Construction of multi-family units (condos, townhomes) increased significantly
- Builders stepped up production
  - Unskilled construction labor
  - “cut corners” - cheaper materials and built quicker
  - Less supervision

Litigation Ensues

- Aggressive plaintiff's bar
- Success in early suits funded additional suits
- Unfavorable legal decisions (discussed later)
- Construction of multi-family units (condos, townhomes) encourages large cases
  - multi-family units four times more likely to sue
- Homeowners associations
  - sold on idea by aggressive lawyers
  - potential suits against condo Board if Board fails to take action
- Spreads into other states

Recent Large Cases [1]

- NV homeowner awarded $14 million – mold-related illnesses due to faulty construction
- $7.8 million awarded to class of 200 NV homeowners – cracking concrete foundations
- $55 million settlement to WA consumers – defective sealant resulting in mold damage
- $4.7 million settlement for WA Condo owners – defective siding, decks, roofs, plumbing, paving and drainage
- $75 million CA class action settlement – defective roofing shakes

[1] Mealey's Litigation Report: Construction Defects

Why a Contractors General Liability/Construction Defect Ratemaking Session?

- Opinion that much more analysis done by reserving actuaries than pricing actuaries?
- Reduction in market capacity creates opportunities for some companies
- Concern over whether current methodologies appropriately reflect the risk
- MGAs looking for assistance in self-insurance options

Construction Defects

- **Questions:**
  - **What are construction defects?**
  - **How should construction defects be dealt with in terms of insurance coverage?**
  - **What methods are used by reserving actuaries in estimating ultimates losses?**
  - **What are the current trends?**
  - **Does current ratemaking methodology appropriately reflect construction defect claims?**
  - **What are the markets doing?**

Sample Definition of Construction Defect Claims

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)

Types of Defects

Many courts have recognized two primary categories of defects for which damages are recoverable:

- **Defects in design, workmanship and materials**
- **Landslide and earth settlement problems**

Examples of Design Defects

- Faulty drainage
- Improper landscaping and irrigation
- Improper materials
- Structural failure or collapse
- Defective plumbing
- Faulty electrical wiring
- Inadequate environmental controls
- Defective lighting or security
- Insufficient insulation
- Poor sound protection

Landslide Problems

- Expansive soils
- Underground water or streams
- Ancient land slides
- Vertical settlement
- Horizontal movement
- Land sliding
- Surface failures
- Improper compaction
- Inadequate grading and drainage

Coverage Under the CGL Policy

The CGL policy covers "property damage" that:

- **Is caused by an "occurrence"; and**
- **Occurs during the policy period**

Definitions

“Occurrence” means an accident, including continuous or repeated exposure to substantially the same general harmful conditions.

“Property damage” means:

- **Physical injury to tangible property, including all resulting loss of use of that property; or**
- **Loss of use of tangible property that is not physically injured**

Damage To Your Work Exclusion

The CGL policy excludes coverage for damage to your work (exclusion l).

- **"Your work" includes work or operations performed by or on behalf of the named insured.**
- **This insurance does not apply to:**

  "Property damage" to "your work" arising out of it or any part of it and included in the "products-completed operations hazard".

<u>Rationale</u>

- **Faulty Workmanship is a business risk.**
- **Business risks are not the subject of the CGL policy. The CGL policy is <u>not</u> intended to provide warranty coverage.**

Damage To Your Work Exclusion

- Many courts have ruled that construction defects fall within the "damage to your work" exclusion.
- This exclusion does not apply if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor.
- Coverage for construction defects can be significantly affected if the insured uses subcontractors

Possible Coverage Scenarios

- **Damage to the insured's work arising out of a subcontractor's work**
- **Damage to a subcontractor's work arising out of the subcontractor's work**
- **Damage to a subcontractor's work arising out of the insured's work**

Damage To Your Work Exclusion -- New Endorsements

Two new endorsements introduced

- **Endorsement CG 22 94 deletes subcontractor exception for all exposures**
- **Endorsement CG 22 95 deletes subcontractor exception for scheduled sites and/or operations**

Other Possible Exclusions

- Damage to Impaired Property or Property Not Physically Injured
- Recall of Products, Work or Impaired Property
- Mold Exclusions
  - Total fungi and bacteria exclusion
  - Sublimit on fungi and bacteria claims
- Optional Exclusion for EIFS Contractors

Additional Insured Status

Reasons for granting additional insured status

- **A close business relationship**
  - **Members of a club**
  - **Condominium unit owners**
- **Contractual agreement**
  - **Property owners on policies of contractors**
  - **General contractors on subcontractors policies**
  - **Owners or lessees of real estate on policies of lessees**

Additional Insured Endorsements

CG 20 10 – major additional insured endorsement for construction operations

- **Adds owner to the policy of a contractor**
- **Adds contractor to policy of a subcontractor**
- **Purpose of AI Endorsements**
  - **Provides coverage for the additional insured's vicarious liability**
  - **Liability must arise out of the named insured's ongoing operations performed for the additional insured**
  - **Completed operations excluded; provided under separate endorsement**

Additional Insured Endorsements

- **Adverse Court Decisions**
  - **Additional insured endorsements typically employ the phrase "arising out of"**
  - **Some courts have ruled that this phrase responds to damage or injury arising out of the additional insured's sole negligence**
- **Changes to Additional Insured Endorsements**
  - **Replace "arising out of" with "caused by" in the additional insured endorsements**
  - **Purpose is to preclude coverage for an additional insured's sole negligence**

Contractual Liability and Sole Negligence

- **Sole negligence may still be covered under contractual liability**
- **Revised “insured contract” definition via new optional endorsement to remove coverage for an additional insured’s sole negligence**

Known Loss

- **Insurability (Fortuity) – Injury or damage must be caused by an occurrence**
- **Known Loss Doctrine – Insurance is a contract whereby one undertakes to indemnify another against loss, damage or liability arising from a contingent or unknown event (California Insurance Code Section 22)**

Montrose Ruling

- **Montrose Chemical Corp. v. Admiral Ins. Co., 10 Cal. 4th 645 (1995)**
  - **Known loss rule held to not apply**
  - **A loss is not known until liability is certain**
  - **Only involved Duty To Defend**
- **<u>Ramifications</u>: Policies issued subsequent to the inception of a continuous injury or damage claim may still apply to indemnity and defense**

Subsequent Decisions

- **Stonewall Ins. Co. v. City of Palos Verdes Estates – California decision extended Montrose ruling to indemnity.**
- **Pittston Co. v. Allianz Ins. Co. – US Court of Appeals for the 3rd Circuit, interpreting NJ law, cited Montrose and approved of its reasoning.**
- **B&L Trucking v. Northern Ins. Co. – Washington Court of Appeals reached conclusions similar to those in Montrose.**
- **Stonehenge Engineering Corp. v. Employers Ins. Of Wausau – Federal Court, interpreting South Carolina law, agreed with the Pittston ruling.**

CGL Policy Intent

A liability policy is not, and has never been, intended to protect the insured against liability arising out of injury or damage known to have occurred, in whole or in part, prior to the inception of the policy.

Addressing Montrose

Objectives:

- **Provide coverage only when the insured was not aware of the injury or damage prior to the beginning of the policy period**
- **Not create any coverage gaps**
- **Not affect the current definitions of “occurrence” and its established interpretations**
- **Gain universal acceptance and approval of the revisions**

Montrose Revision

- **Revision to Insuring Agreement**
- **No new exclusions**
- **CGL Policy revised to state that coverage does not apply, under any circumstances, to injury or damage that is known by the insured prior to the policy period.**
- **If injury or damage is known prior to the beginning of the policy period, any continuation, change or resumption of that injury or damage during or after the policy period will also be considered to have been known prior to the beginning of the policy period, and not covered.**

Montrose Revision

- **Avoiding potential coverage gaps – Injury or damage that occurs during the policy period but was NOT known prior to the beginning of the policy period includes any continuation, change or resumption of that injury or damage after the end of the policy period.**
- **Who must know:**
  - **Any Insured listed in Paragraph 1. of Who Is An Insured (essentially Named Insureds)**
  - **Any employee authorized to give or receive notice of an occurrence or claim (e.g., a risk manager)**

Montrose Revision

- **Injury or damage is known at the earliest time when any designated insured:**
  - **Reports all, or any part of it, to the insurer or any other insurer;**
  - **Receives a demand or claim for damages because of it; or**
  - **Becomes aware by any other means that it has occurred or begun to occur.**
- **Addresses specific known injury or damage**
- **Does not address known circumstances**
- **No known court decisions on this new language yet.**

Completed Operations Data

- ISO Data
- Data does not identify construction defects claims
- Basic Limits Data
- Completed Operations
- Looked at latest 5 years (1998 – 2002)

Number of Completed Operations Occurrences

STATE	1998	2000	2002	5 Yr.
AZ	153	83	39	448
CA	527	471	172	1,938
CO	218	148	66	701
NV	189	123	36	561
OR	141	95	63	504
WA	267	180	100	947

Number of Completed Operations Occurrences

STATE	1998	2000	2002	5 YR.
ALL	7,052	6,671	4,822	31,305
SC	163	84	96	584
FL	158	290	272	1,367
TX	224	181	225	1,086

$ Per Occurrence

NAME	1998	2000	2002	5 YR
AZ	60,713	132,166	64,468	80,374
CA	69,752	64,289	99,444	71,014
CO	62,571	58,258	66,786	59,407
NV	77,999	74,151	54,903	76,169
OR	59,223	72,199	68,988	58,571
WA	107,191	130,229	112,491	123,555

$ Per Occurrence

STATE	1998	2000	2002	5 YR.
ALL	42,473	43,409	49,263	44,125
SC	87,635	165,463	136,781	114,642
FL	38,742	44,337	64,413	49,692
TX	31,226	48,026	68,675	50,361

Basic Limits Experience Ratios

STATE	1998	2000	2002	5 YR
AZ	1.400	2.071	0.622	1.371
CA	0.756	0.878	0.480	0.712
CO	2.232	1.493	1.124	1.580
NV	2.672	2.184	0.608	1.980
OR	1.843	1.424	1.219	1.377
WA	2.691	2.461	1.344	2.462

Basic Limits Experience Ratios

STATE	1998	2000	2002	5 YR
ALL	1.248	1.325	1.181	1.254
SC	2.710	3.016	2.975	2.803
FL	0.957	1.396	1.948	1.422
TX	0.837	1.185	2.328	1.454

Major Exposed Classes of Business

- General contractors
- Sub-contractors
- Artisans (e.g., plumbers, landscapers, electricians)
- Owners and developers
- Real estate managers
- Architects and engineers
- Manufacturers of construction and building products-roofing materials, plumbing systems, windows and doors, drywall, stucco and siding

- Claims found under
  - Products/Completed Operations
  - PD

Why Are CD Claims So Complicated?

- Reporting lag
- Statute of limitation (patent vs. latent)
- Continuous trigger
- Multiple claimants
- Multiple defendants
- Multiple insurance companies
- Litigious environment
- Additional insured endorsements

Claim Coding - What is the accident date?

- Due to Montrose, the claim can trigger any policy between the date of project completion or the date of third-party damage and the date of remediation
- Insurers may not code claims consistently
  - Record entire claim in policy period where project was completed or first effective policy thereafter. As policy limits are extinguished open up new claim on next policy
  - Record a claim in every policy effective between completion and remediation
  - Record expense on only one policy or multiple

Coding of CD claims to Accident year

- Home built in 1995
- Claim reported in 2002
- Company A sold contractor policy from 1993 through 2002

	12	24	36	48	60	72	84	96
1995								1
1996								
1997								
1998								
1999								
2000								
2001								
2002								

Coding of CD claims to Accident year

- Home built in 1995
- Claim reported in 2002
- Company A sold contractor policy from 1993 through 2000
- Company B sold contractor policy from 2001 through 2002

	12	24	36	48	60	72	84	96
1995								1
1996								
1997								
1998								
1999								
2000								
2001		1						
2002								

Coding of CD claims to Accident year

- **Solution: Code claim count to each year for which a policy is exposed**

	12	24	36	48	60	72	84	96
1995								1
1996							1	
1997						1		
1998					1			
1999				1				
2000			1					
2001		1						
2002	1							

Issues to Address

When setting reserves, it is critical to obtain background information on the following topics:

<u>Exposures/Underwriting</u>

- **Policy year**
- **California and Other States**
- **Residential v. Commercial**
- **Developer/Contractor v. Subs/Artisans**
- **Changes in mix by SIC codes, class, etc.**
- **Primary and/or excess**
- **Endorsements/coverage restrictions**
- **Premium and exposures**
- **Other mitigation efforts**

Issues to Address (Cont.)

Coding/Availability of Data

- By report year and accident year
- Definition of CD claim
- Coding of accident year
- Limits
- Reinsurance
- Sub-classes
  - additional insured endorsements
  - EIFS
  - mold

Issues to Address (Cont.)

Claim Adjusting/LAE

- Changes in claims handling philosophy
- Reserve setting practices
  - e.g., independent or formula reserves
- Treatment of ALAE as regards reinsurance (in or out of limit)
- Changes in reserving methodology

“Recommended” CD Reserving Methodology

- **Combination of Report Year Loss Development and Frequency/Severity Method for “Pure” IBNR**

  Ultimate Loss and ALAE =
  Reported Loss and ALAE
  +Supplemental development
  + Estimated Loss and ALAE IBNR

  where IBNR=
  IBNR claim counts
  x (% claims closed with payment)
  x (average future severity for claims closed with payment)

“Recommended” Approach

- **Combination of Report Year Loss Development and Frequency/Severity Method for “Pure” IBNR**
  - **Once claim is reported , it is settled relatively quickly**
  - **Less uncertainty for the reported loss emergence**
  - **Ability to isolate changes in claims handling**
  - **Allows scenario testing of pure IBNR**
- **For reasonability check, compare results against other methods used**
- **Can allocate costs back to accident year**

“Recommended” Approach (Cont.)

- **Analyze accident year and report year data**
  - **cumulative, incremental, loss development factor basis**
  - **loss development - paid and reported, loss & ALAE separately**
  - **claim count development - reported, CWP, CWNP**
  - **paid/reported ratios**
  - **severities - paid, paid-on-closed, reported**
  - **count ratios - closed/reported, CWP/closed, CWNP/closed**
  - **large loss data**
  - **net/gross ratios**

“Recommended” Approach (Cont.)

- **Report Year Loss Estimation**
  - **Generally, loss development approaches work well for estimating supplemental reserves on known claims**
  - **Take care to adjust for changes in claims handling practices**
  - **Monitor results using diagnostic testing**
    - **Develop claim counts**
    - **Examine closure rates**
    - **Review reported, paid, outstanding, and ultimate severities**

“Recommended” Approach (Cont.)

- **Frequency/Severity Method for “Pure” IBNR**
  - **Estimate future claim counts using four methods**
    - **Accident year claim count development method**
    - **Accident year claim count development method with tempered LDFs**
    - **Exposure based emergence**
    - **Bornhuetter-Ferguson Method**

“Recommended” Approach (Cont.)

- **Frequency/Severity Method for “Pure” IBNR**
  - **Exposure base emergence**
    - **Assume exposures for a specific year are evenly spread out over the statute of limitations**
    - **Reorganize the exposures on an report year basis**
    - **Calculate the report year frequency**
    - **Apply the selected frequency against the future report year exposures to estimate future claim emergence**
    - **See example on next page**

"Recommended" Approach (Cont.)

Exposure Based Method
To Estimate IBNR Claim Counts

Accident Year	Earned Exposures	Report Year 1	2	3	4	5	6	7	8	9
1	10	10	10	10	10	10				
2	35		35	35	35	35	35			
3	60			60	60	60	60	60		
4	80				80	80	80	80	80	
5	50					50	50	50	50	50
(1) Report Year Exposures		10	45	105	185	235	225	190	130	50
(2) Report Year Claim Counts		2	8	18	35	40				
(3) Report Year Frequency (2) / (1)		0.200	0.178	0.171	0.189	0.170				
(4) Selected Frequency							0.178	0.178	0.178	0.178
(5) IBNR Claim Counts (4) x (1)							40	34	23	9

“Recommended” Approach (Cont.)

- **Frequency/Severity Method for “Pure” IBNR (Cont.)**
  - **Estimate loss severities**
    - **using paid on closed claims**
    - **using reported losses and estimated CWP**
    - **make adjustments for large losses**
    - **select trend factor**

“Recommended” Approach (Cont.)

- **Frequency/Severity Method for “Pure” IBNR (Cont.)**
  - **Estimate ALAE component**
    - **Similar approach to loss**
    - **Use ALAE to loss ratio**
    - **Segment additional insured expenses and analyze separately**

Trends

- **Claim counts**
  - **Depends upon when reduced exposure**
  - **Reported peaked in 2000 to 2001, started decreasing in 2002**
    - **mostly from mid 1990s accident years**
  - **Some companies saw spike in 2003 - (could be mold or additional insured claims)**
- **Severity**
  - **Appears to be decreasing**
  - **Larger claims settled or in litigation**
  - **Impacted by more defendants**
  - **Depends on contractor or subcontractor - additional insured endorsement**

Trends (Cont.)

- New States
  - AZ, CO, FL, NV, NM, NC, OR, SC, TX, WA and WY
- Developer v. subcontractor
  - developer used to pay 50% - 60%; now pays 20% - 30%[1]
  - developers may be running out of limits
- ALAE/Loss
  - ALAE currently ranges from 80% to 110% of loss
  - Ratio rising - impacted by lower loss payments and possibly increasing additional insured (AI) exposure

[1] Thomas E. Miller, California Attorney

Trends (Cont.)

- CWP/Reported ratios
  - Decreasing
  - Quick coverage denials/”shot gun” approach
- Reinsurance
  - Lower severities leading to less recoveries
- Consideration of insolvent insurers
  - Remaining companies to share loss
  - California Insurance Guarantee Association - denies coverage if other insurance is available
- General contractors running out of limits

ISO Disclaimers: Company Decision

- **“We encourage each insurer to decide independently whether the judgments made and the procedures or data used by ISO in developing the indications contained herein are appropriate for its use…”**
- **“…an individual company may benefit from a comparison of its own experience to the aggregate ISO experience, and may reach valid conclusions with respect to the manner in which its own costs can be expected to differ from ISO’s projections based on aggregate data…”**
- **“…Each company should carefully review and evaluate its own experience in order to determine whether the indications are appropriate for its use.”**

ISO Basic Limits Ratemaking Approach for Local Products/Completed Operations

- **Step 1: Determination of Indicated Loss Cost Level Changes**
  - **Determine multistate loss cost level indication**
- **Step 2: Distribution of Loss Cost Level Indication**
  - **The multistate basic limit loss cost level change is distributed to the individual types of policy, class groups, and state using simultaneous Bailey's procedure.**
- **Step 3: Application of Percentage Changes**
  - **Proposed state loss costs are calculated using a Bayesian credibility procedure**
  - **In order to increase credibility, multistate experience is used in determining the class index**
  - **Where capped, this result is multiplied by a "buildback" factor to ensure that the selected overall statewide rate change is achieved**

ISO Basic Limits Ratemaking Approach for Local Products/Completed Operations - Questions

- **Step 1: Determination of Indicated Loss Cost Level Changes**
  - **Determine multistate loss cost level indication**
  - ***What impact is there in using the multistate loss cost level indication?***
  - ***There might not be enough volume to review local products by state***
- **Step 2: Distribution of Loss Cost Level Indication**
  - **The multistate basic limit loss cost level change is distributed to the individual types of policy, class groups, and state using simultaneous Bailey's procedure**
  - ***Does the multistate distribution process appropriately reflect the state differences?***

ISO Basic Limits Ratemaking Approach for Local Products/Completed Operations - Questions

- **Step 3: Application of Percentage Changes**
  - **Proposed state loss costs are calculated using a Bayesian credibility procedure**
  - **In order to increase credibility, multistate experience is used in determining the class index**
  - **Where capped, this result is multiplied by a "buildback" factor to ensure that the selected overall statewide rate change is achieved**
  - ***Does the use of the multistate experience in determining the class index suppress "problem state" loss costs.***
  - ***Are classes with CD exposure being capped and subsidized by other classes?***

Issues with ISO approach on Contractors Ratemaking

- **Indications based on data evaluated as of 12/31/2001:**
  - **1999 (20% weight)**
  - **2000 (30% weight)**
  - **2001 (50% weight)**
- **For allocation to rating variables – 5 years of data is used**

Concern:

Many companies coding claims to older accident years

ISO CA Advisory Loss Costs
Local Products/Completed Operations

	Years	Indicated	Selected	Remainder
GL-1999-BGL1	10/1994-9/1997	+606.0%	+50.0%	+370.7%
GL-2000-BGL1	10/1995-9/1998	+280.7%	+50.0%	+153.8%
GL-2001-BGL1	10/1996-9/1999	+161.9%	+50.0%	+74.6%
GL-2003-BGL1	10/1998-9/2001	-28.1%	-20.0%	-10.1%

Are the loss costs decreasing since CD claims are coded to older years not in the experience period?

Issues with ISO approach on Contractors Ratemaking

- **Change in the companies included in the review can affect loss costs**
  - **For GL-2003-BGL1, CA loss costs dropped by -18.5%**

Concern:

Will the insolvencies of companies writing contractors be an issue?

What about companies voluntarily withdrawing from the market?

Issues with ISO approach on Contractors Ratemaking

- **Assumes frequency trend of 0% and severity trend of 7%**

Concern:

Are CD trends similar to overall Local Products/Completed Operations trends?

- ***Frequency trend over what was anticipated seems to be increasing***
  - ***"Shotgun" approach to naming defendants***
  - ***Additional insured endorsement***
- ***Severity decreasing as more defendants***

Issues with ISO approach on Contractors Ratemaking

- **Methodology for ALAE**

Concern:

Does methodology reflect ALAE-to-loss ratios of 50% to 110% and reflect impact of additional insured endorsement?

Issues with ISO approach on Contractors Ratemaking

- **Application of loss development**
  - **Statewide experience is credibility weighted with multistate experience**

Concern:

Reserving actuaries don't rely on standard loss development methodologies

What the markets are doing

- Coverage terms and conditions
- Pricing
- Product offerings

The main response by insurers has been to restrict coverage in numerous ways:

- No Residential
  - Underwriting guidelines
  - Exclusions
- Damage to Your Work and Subcontractor exclusions
- Mold exclusion
- EIFS exclusion
- Reduce products/completed operations tail coverage
- Montrose exclusion
- Earth movement exclusion
- New Additional Insured endorsement

The moral of the story is…

Companies are only offering coverage they can price or make rates for!

Pricing is being used as an indirect way to address the issue(s)

- Some insurers seem to ignore
  - Though this is very difficult in today's reinsurance environment
- Rate strengthening
- Risk loads
- Zurich approach

- Note: approaches may vary depending on size of account (e.g. small, middle or large).

There is some (but not much) creative thinking being done

- Calderon Act & Steinberg Bill
- Other mandatory dispute resolution processes
- Home Builders Protective Program (HBPP)
- Subguard®
- CCIPs (Contractor-controlled insurance programs)
- Captives
- Casualty Loss Mitigation™
- Other examples

Food for thought

<u>Preface</u>: Adjustments in the marketplace have been underwriting" in nature and not "actuarial" per se, but actuaries need to understand the adjustments being made in order to assess rate adequacy.

How does one measure so many moving parts?

- Jurisdiction
- “Occurrence”
- “Expected or Intended”
- Damages
- “Property Damage”
- Your Work exclusion
- Bodily Injury or Property Damage imminent as the result of defective work.
- Customer Expectations?
- Residential construction
- Breach of contract
- Mold
- EIFS
- Montrose
- Additional Insured
- Duty to defend

Some lessons learned

- Construction Defect is not just a California issue.
- To lesser degree, Construction Defect is not just a Residential issue either.
- How are construction defect exposures underwritten?
  - E.g. QA/QC procedures
  - Shift in work mix, etc.
- Documentation by contractors.
- Contracts and indemnification
- Individual risk rating.

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