

2008 CAS Ratemaking Seminar

***Contractors General Liability  
and Construction Defects***

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## Contractors general liability

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- Insureds: homebuilders, general contractors, artisans, suppliers
- Types: practice, project, wraps
- Residential vs. commercial
- Single family vs. multi-family
- Primary or excess
- Policies: policy forms, coverages, exclusions, additional insured endorsements
- Coverage: premises & operations, completed operations (construction defect), warranty
- Exposure period: occurrence, claims-made, sunset provisions
- Exposures: homes, sales/revenue, budgets, payroll
- Decreasing housing prices, less construction
- Competition, new entrants, decreasing rates

## California Population Growth and Housing Supply Shortage

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- In the late 70s through early 90s, California experienced unprecedented population and housing growth
- CA population growth was twice the US population growth rate during parts of period
- 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 shorter construction time
  - Less supervision



## Litigation Ensues

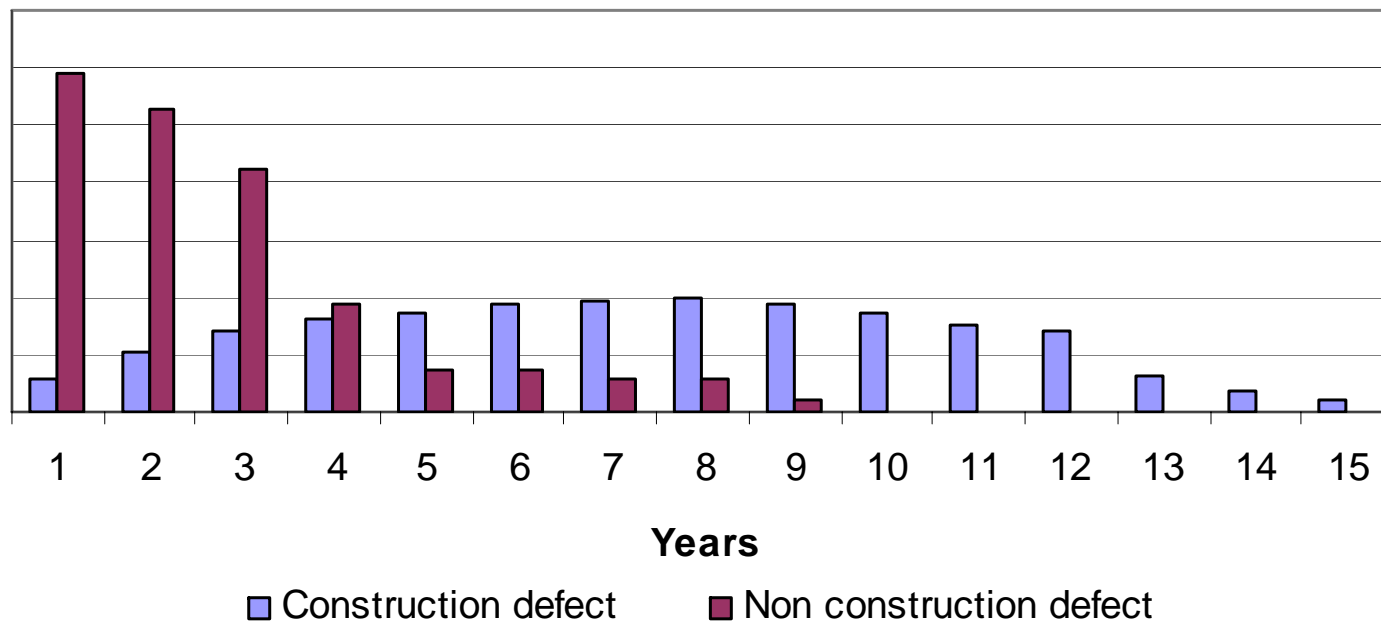
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- Aggressive plaintiffs bar in California
- Success in early suits funded additional suits
- Unfavorable legal decisions (Montrose, Stonewall)
- Construction of multi-family units (condos, townhomes) encourages large cases
  - multi-family units four times more likely to sue
- Homeowners associations
  - sold on idea by aggressive lawyers
  - potential suits against condo board for failure to take action
- Spreads into other states
  - lawyers move east
  - states use different “theories of liability” and definition of “occurrence”

## Premises & operations and completed operations (construction defects) have significantly different reporting patterns

- The majority of non construction defect losses are reported as of four years, whereas construction defect claims have a significantly slower reporting pattern.

### Incremental Reporting Patterns



Based on California reporting patterns

## Products and Completed Operations Loss Costs for Specific Contractors Classes 2000-2006 - Oregon

<b>Class</b>	<b>2000-2006 Loss Cost Change</b>	<b>Annual Loss Cost Change</b>
Siding Installation	411.9%	31.3%
Ceiling or Wall Installation - Metal	356.0%	28.8%
Painting - Exterior Bldgs. - > 3 stories	347.8%	28.4%
Sign Painting or Lettering - Inside Bldgs.	335.4%	27.8%
Plastering or Stucco Work	315.9%	26.8%
Insulation Work - Plastic	300.0%	26.0%
Painting - Steel Structures or Bridges	267.4%	24.2%
Dry Wall or Wallboard Installation	266.1%	24.1%
Plumbing - Commercial and Industrial	243.1%	22.8%
Roofing - Residential	222.7%	21.6%
Concrete Construction	203.5%	20.3%
Plumbing - Residential or Domestic	186.6%	19.2%
Masonry	155.5%	16.9%
Electrical Work - Within Bldgs.	136.5%	15.4%
Roofing - Commercial	98.7%	12.1%
Driveway, Parking Area, or Sidewalk	76.3%	9.9%
Floor Covering Installation	65.1%	8.7%
Fence Erection Contractors	62.3%	8.4%
Heating and Air Conditioning Systems	55.5%	7.6%
Tile, Stone, Marble, Mosaic, or Terrazzo Work	51.6%	7.2%
Sheet Metal Work - Shop and Outside	26.0%	3.9%
Electrical Apparatus - Installation, Service, & Repair	12.9%	2.0%

## Why is analyzing CD claims so complicated?

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- Definition
- Construction defect vs. warranty
- Reporting lag/statute of limitation
- Multiple claimants/defendants/insurance companies
- Effects of court decisions
- Changes in policy form and introduction of exclusions
- Additional insured endorsements
- Coding to an accident year
- Specific states developing into problematic states
- “Notice & opportunity to repair laws”
- Case reserving practices
- Binding arbitration clauses



## Why is analyzing CD claims so complicated? (cont'd)

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- Increased use of SIRs/deductibles
- Wrap policies
- Quality of construction
- Insolvencies/possible impact of RRGs
- Implementation of claims-made and sunset provisions
- Reallocation of prior cost allocations
  
- Continuously changing environment
- Overall concern that past may not be predictive of the future





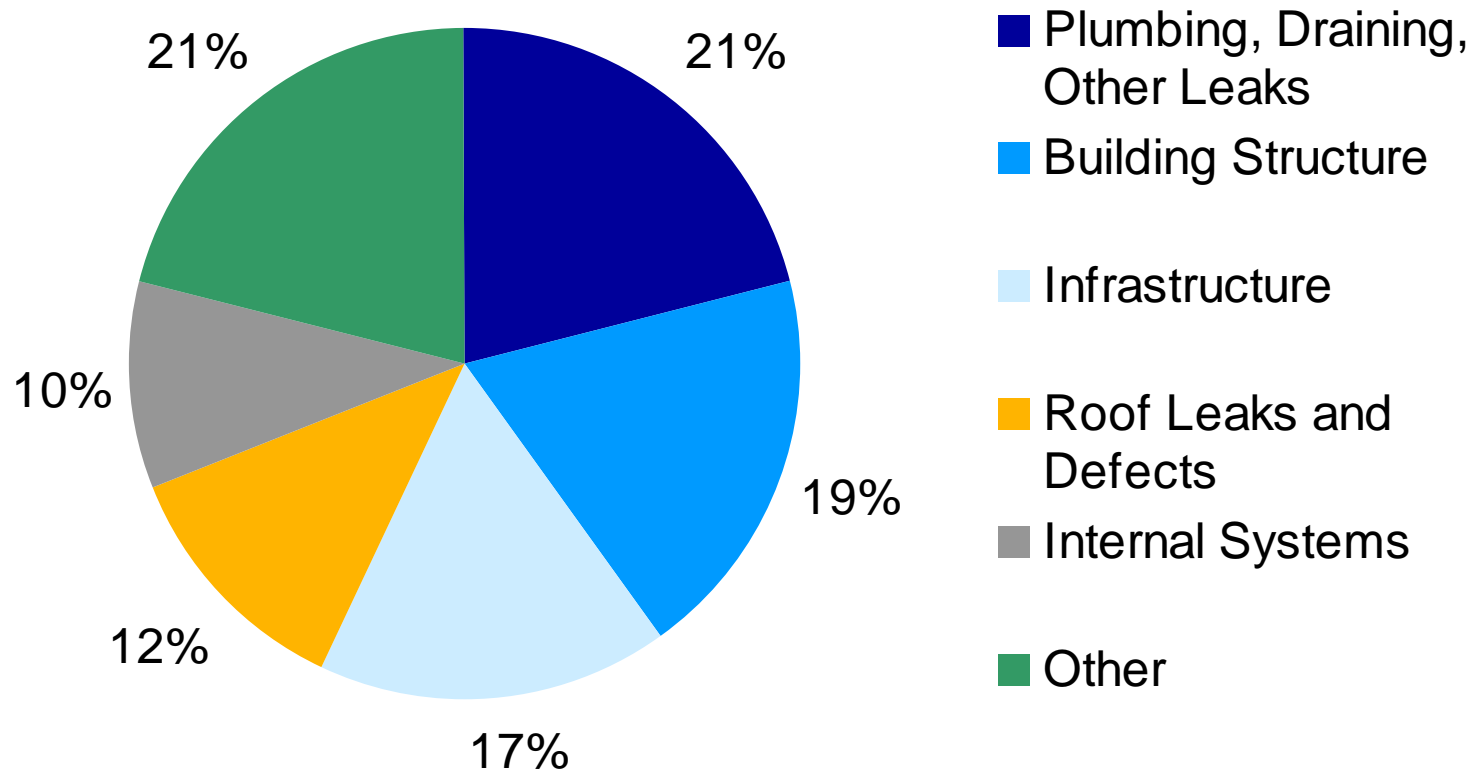
## Types of Defects

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- Many courts have recognized two primary categories of defects for which damages are recoverable:
  - Defects in design, workmanship and materials
    - Faulty drainage
    - Improper landscaping and irrigation
    - Improper materials
    - Structural failure or collapse
    - Inadequate environmental controls
    - Faulty electrical wiring
    - Insufficient insulation
    - Defective plumbing
  - Landslide and earth settlement problems
    - Expansive soils
    - Underground water or streams
    - Vertical settlement
    - Horizontal movement
    - Land sliding
    - Surface failure
    - Improper compaction
    - Inadequate grading and drainage
- Patent defects vs. latent defects
- CGL covers damage resulting from defects
  - No coverage from “your own work”; different from warranty

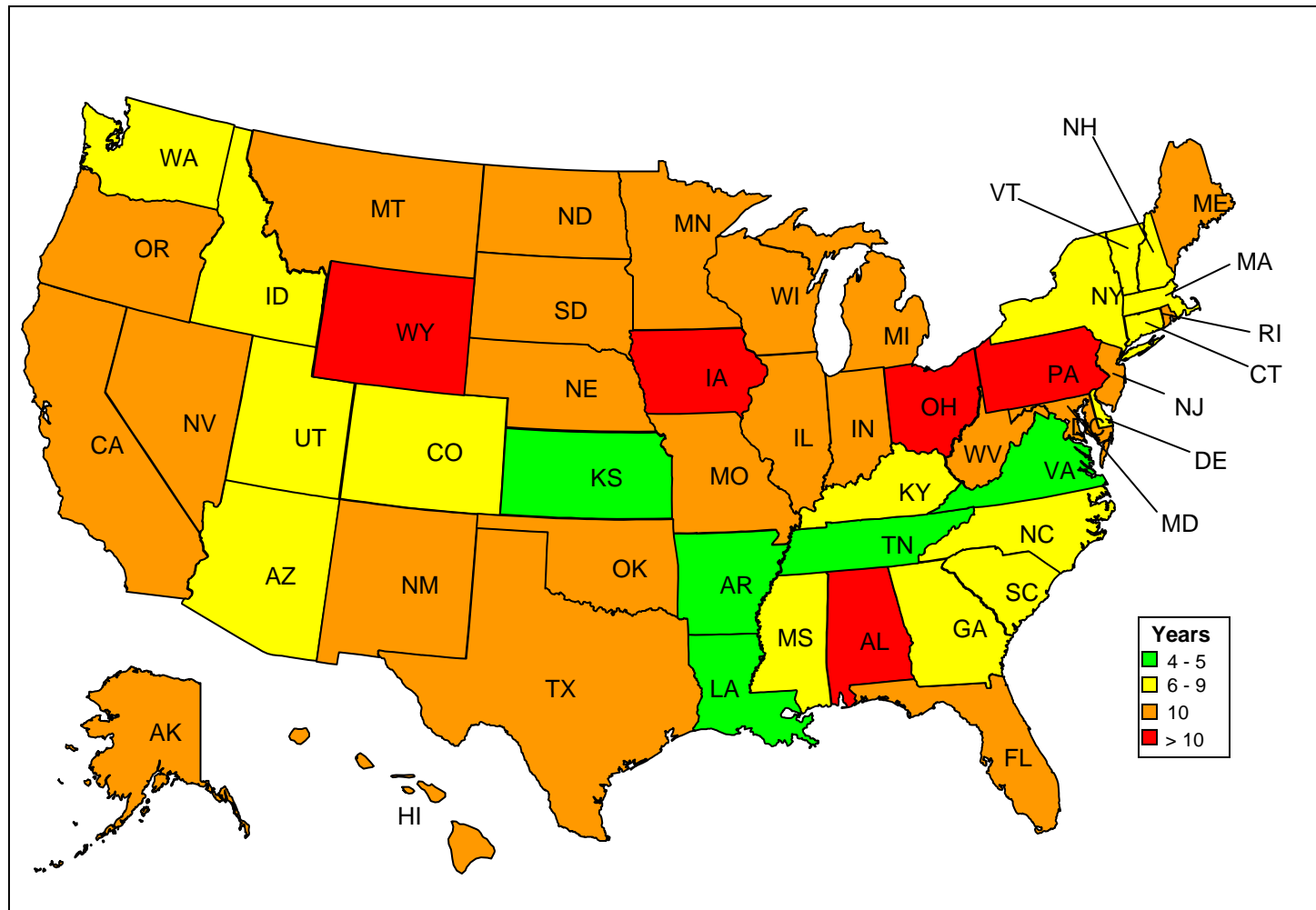
## Type of Defects (cont'd)

### Most Common Types of Construction Defects



Source: California Department of Real Estate/IRMI Conference

# Statutes of Repose



## Important Legal Cases (California)

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- I - Montrose Chemical Corp v. Superior Court (Canadian Universal Insurance Co) – 1993
  - an insurer must defend an insured in a case involving the discharge of hazardous substances
- II - Montrose Chemical Corp v. Admiral Insurance – 1995
  - continuous trigger
- Stonewall Insurance Co. v. City of Palos Verdes Estates – 1996
  - Montrose applied to construction defects
- Aas v. William Lyon Company – 2000
  - defect without resultant damage is not sufficient for a liability claim
- Presley Homes v. American States Ins. Co. – 2001
  - duty to defend the entire action applies if there is a mere potential for coverage
- Lantzy v. Centex Homes – 2003
  - addressed “tolling of the statutes”
- L-J v. Bituminous Fire and Marine Ins. Co. – 2004
  - no coverage provided to your own work (“your work” exclusion)

## Changes in Policies

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- Some policy changes/endorsements shift coverage whereas others eliminate coverage
  - Montrose endorsement
  - Known loss provisions
  - Prior work exclusions
  - “Damage to Your Work” exclusion
  - Additional insured endorsements
  - EIFS exclusion
  - Mold exclusions
  - Earth movement exclusions
  - Residential construction exclusions
  
- Need to consider how other insurer’s policies are changing
- Most companies only estimate benefits



## Additional Insured Endorsement

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- Issues\*
  - Coverage for “ongoing operations” vs. “completed operations”?
    - Is policy silent, “includes” or “excludes”
  - Does coverage specify that liability must “arise out of the named insured’s ‘act or omissions’ ”?
  - Does coverage terminate for the additional insured when the named insured’s work is completed?
  - Does language limit coverage to the AI’s vicarious liability for acts of the named insured?
- Cost sharing arrangements
  - Decided early in the suit
  - Pro-rata, tiered, percentage
- Are you tracking use of AI endorsements?
- Can you estimate impacts?



\*Source: American Re Construction Defect: Resource Guide, 2005

## States where insurance companies have concerns over construction defects

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- 1st tier – California
- 2nd tier – AK, AZ, CO, FL, HI, MN, NJ, NV, NM, NC, OR, SC, TX, WA
- 3rd tier – all other states
- Katrina, Rita, and Wilma affected states - LA, MS, AL, FL
- What to watch out for
  - Rapid growth in population
  - Rapid growth in construction
  - Unskilled labor
  - Legal environments
  - Theories of liability
  - Judicial environment



## “Notice and Opportunity to Repair” Legislation

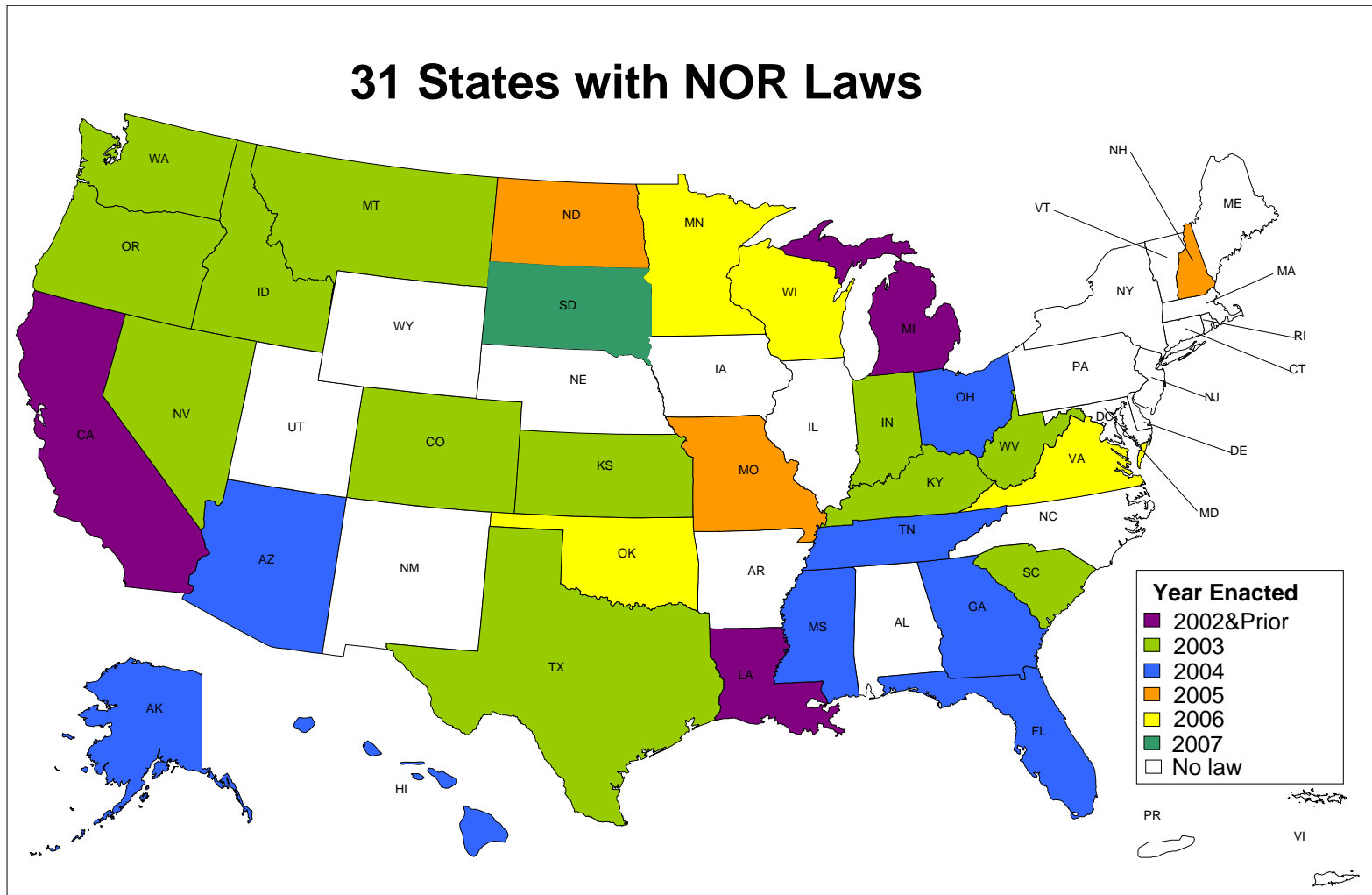
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- Generally provide builder with written notice and description of alleged defects - 90 days before filing lawsuit
- Intent
  - decrease frivolous law suits
  - reduce legal costs
- California - Calderon Act - 1997
  - homeowners association must provide notice of a claim to the developer and to the members of its association before filing a lawsuit
- California - Steinberg Mandatory Negotiation Bill (7/2002)
  - builders, subcontractors, insurers and suing homeowners will be required to negotiate a solution to specific alleged defects in a timely manner before a lawsuit can be filed
- California Senate Bill 800 (“Fix It” Law) – 2003
  - established building standards to govern claims against builders
  - mandatory pre-lawsuit process





## “Notice and Opportunity to Repair” Legislation (cont'd)



\*Source: National Association of Home Builders (NAHB); if more than one NOR – chart shows year of latest reform

## Cost Allocation Matrix

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- Cost allocation matrix and coding of claims to accident year may have changed drastically over the past ten years
- Less spreading of claims may mean lower frequency and higher severities
- Past may not be a good predictor of future
  - Faster reporting of claims may be more than offset by changes in policy language
  - Impacts dependent upon many factors



## Actuarial Analysis – Exposures/Underwriting

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- Homebuilders, general contractors, artisans, suppliers
- Practice, project, wraps
- Residential vs. commercial
- Residential : single family vs. multi-family
- Primary or excess
- States
- Policy forms, coverages, exclusions, additional insured endorsements
- Premises & operations, completed operations (construction defect), warranty
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## Actuarial Analysis - Issues to Address

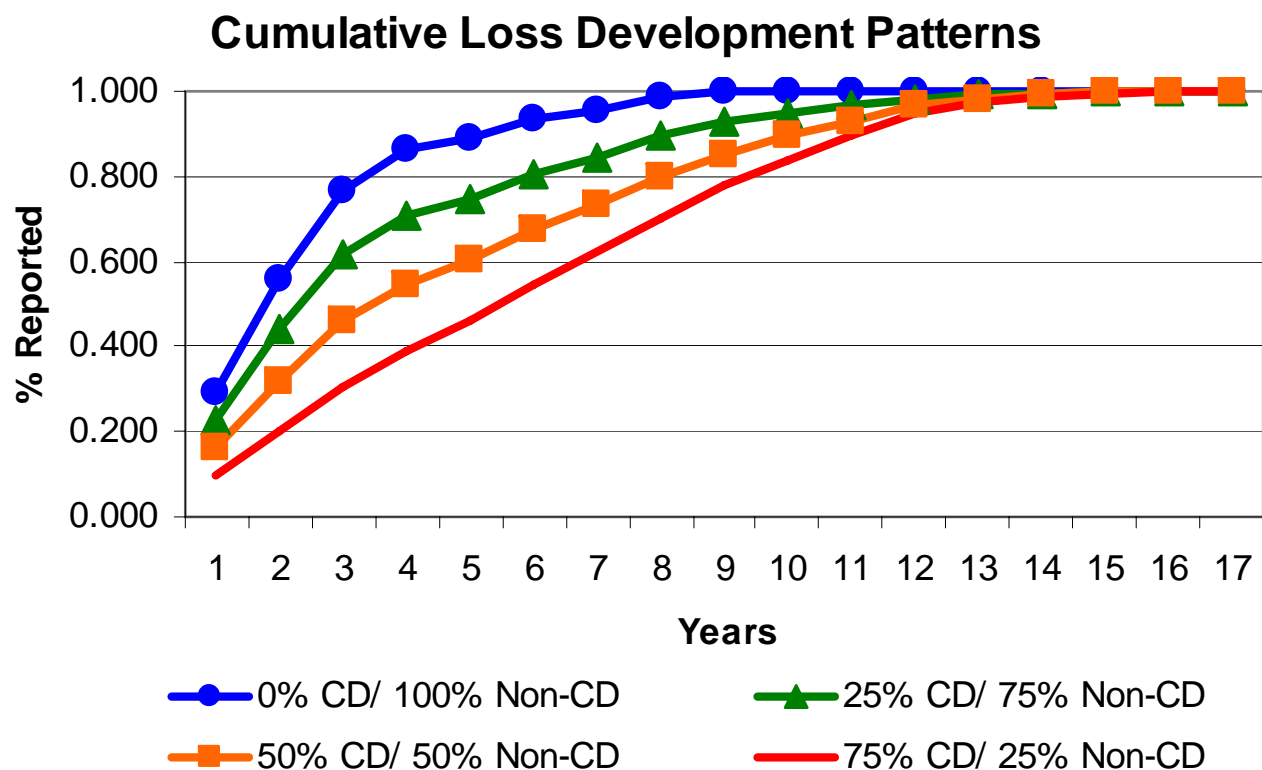
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- Coding/availability of loss data
- California and other states
- Residential vs. commercial
- Single family vs. multi-family
- Developer/contractor vs. subs/artisans
- Definition & mix of CD/non CD claims
- Report year triangles
- Accident/COE triangles
- Individual claim listing
- Sub-classes (EIFS, mold, AI)
- Missing case reserves
  - Insurers – ALAE
  - Homebuilders – loss or ALAE
- Claim counts
  - Reported, closed
  - CWP, CWNP
  - CWIP, CWEP
- Limits/reinsurance/wrap
- ALAE - inside or outside of limits



## The mix of construction defect to non-construction defect claims is important

- The mix of construction defect losses and non construction defect losses is important to understanding the potential reporting pattern.



Based on California reporting patterns

## Traditional actuarial methods may not be good predictor

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- Loss development methodologies assume that past is a good predictor of the future
- Construction losses have been affected by a constantly changing environment
- Better to use frequency and severity methodologies
  - Management can understand results
  - Monitoring of results is easier
- Use Accident Year Claim Count Emergence and Report Year Loss & ALAE Development  
= Accident Year Loss & ALAE Development



## Question the reasonableness of your rates

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- ISO experience more credible in eastern states as compared to western states
  - excess & surplus lines insurers more prominent on west coast
- Need more residential vs. commercial splits
- Influence of classes upon another
- Differential between prem/ops and completed ops
- Differential between states
  - possible grouping of states with similar characteristics
    - statute of repose
    - theories of liability
    - judicial environment





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