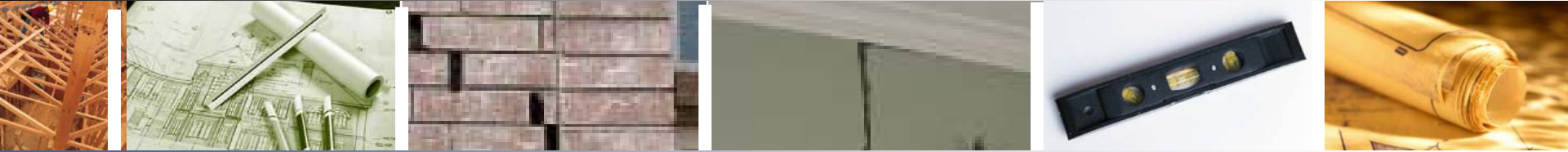




**TOWERS
PERRIN**

TILLINGHAST

Construction Defects



CAS Spring Meeting

Presented by:

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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



California 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**



California - Reducing Exposures

- Many carriers exited the market starting as early as 1992
- Some carriers reduced exposure to “target classes” like residential contractors but continued to write commercial contractors and subcontractors
- Many carriers placed “known and continuing” endorsements or Montrose endorsements on policies beginning as early as 1996
 - standard ISO Form denies coverage for claims that were known prior to the policy period
 - some carriers are even more restrictive, excluding claims first occurring prior to the policy period
- New multi-family units in California drop from 18,681 in 1994 to 2,945 in 1999
- Today many contractors looking at self-insurance and captive options



Arizona

- **Over the past 15 years Arizona's population has increased significantly as evidenced by the increase in building permits**
 - **1991 – 13,700**
 - **2004 – 45,000+**
- **Phoenix is now the sixth largest city in the U.S.**
- **CD litigation has increased significantly in both the number of suits being filed and the frequency**
 - **CA Plaintiff's lawyers and experts now appearing in AZ courts**
 - **Seeing class action attempts rising**
 - **Still a challenge, but they are being approved**



Nevada

- **High demand and fast growth**
 - **Since the early – mid 1990's NV's population has increased 66.3%**
 - **During that same period of time the home ownership rate has increased 60.9%**
 - **Deterioration in construction quality**
 - **Number of CD lawsuits has increased significantly**
 - **227 = number of construction defect lawsuits in Clark County, NV District Courts at end of 2002****
 - **7.5% = percentage of all cases in Clark County NV District Courts at end of 2002 that were construction defect in nature****



Types of Defects

- **Many courts have recognized two primary categories of defects for which damages are recoverable:**
 - ▶ **defects in design, workmanship and materials**
 - ▶ **soil problems (including improper compaction, inadequate grading, inadequate drainage, expansive soil, landslide, earth settlement problems)**



CD Most Commonly Alleged Defects

- Roofing
- Sheet Metal Flashing
- Lath & Plaster
- Soils
- Rough Framing
- Waterproofing
- Doors & Windows
- Concrete
- Painting
- Masonry
- Design & Plan Deficiencies
- Site Work
- Metals
- Carpentry
- Thermal & Moisture Protection
- Finishes
- Specialties
- Mechanical
- Electrical
- Water Damage/Fungus/Dry Rot/Structural Pest Control



Important Legal Cases

- **I - Montrose Chemical Corp v. Superior Court (Canadian Universal Insurance Co) - 1993**
 - **an insurer must defend an insured in case involving the discharge of hazardous substances**
 - **even if the complaint only alleges property damage that would trigger coverage**
- **II - Montrose Chemical Corp v. Admiral Insurance - 1995**
 - **continuous trigger: all insurers with potential for “property damage” during policy period - Applies to duty defend only**
 - **does not address allocation among insurers**



Important Legal Cases (Cont.)

- **Stonewall Insurance Co. v. City of Palos Verdes Estates - 1996**
 - **first post-Montrose v. Admiral case to examine duty to indemnify in context of construction defect claims**
 - **continuous trigger of coverage determines the obligation of successive liability insurers to indemnify**
- **Combined effects:**
 - **increased ALAE due to defense requirement**
 - **more limits at risk; increased severity**
 - **multiple carriers on many claims**
 - **significant claim count increases**



Important Legal Cases (Cont.)

- **Aas v. William Lyon Company - 2000**
 - **Supreme Court decision disallowing negligence claims for construction defects unless damage has actually occurred (a defect without resultant damage is not sufficient for a liability claim)**
 - **physical injury to property**
 - **does not define property damage**
 - **claims for defects must be brought under home warranties instead**
 - **unfortunately, only removes one theory of liability and plaintiffs have been successful using other avenues against insurance policies**



Important Legal Cases (Cont.)

- **Presley Homes v. American States Insurance Co. - 2001**
 - **Presley tendered its defense to subcontractor's insurer via additional insured endorsement**
 - **insurer offered to pay share of Presley's costs, assuming it had duty to defend only on those suits where subcontractor was named insured and only a portion of it**
 - **court ruled**
 - **duty to defend applies where there is mere potential for coverage**
 - **duty to defend applies to entire action**
 - **effects**
 - **shifts ALAE costs from contractor to subcontractor**
 - **more defendants (claims), lower severity (ALAE only)**



Important Legal Cases (Cont.)

- **Lantzy v. Centex Homes – 2003**
 - **addressed whether the absolute ten-year rule was subject to any type of equitable tolling**
 - **CA Supreme Court ruled**
 - **statute provided no exception for the ten-year rule based upon periods of repair**
- **L-J v. Bituminous Fire and Marine Ins. Co. – 2004**
 - **no coverage provided to your own work (“your work” exclusion)**
 - **plaintiff alleged that if subcontractor performed work then exclusion does not apply**
 - **S.C. Supreme Court disagreed**
 - **stated that since no “occurrence” – no need to address “subcontractor exception” to the “you work” exclusion**



Important Legal Cases (Cont.)

- **California Pacific Homes (CPH) v. Scottsdale Ins. Co.**
 - **CPH had five policies in effect during loss period which each had a \$250,000 deductible**
 - **Scottsdale stated CPH needed to apply the deductible for each policy period before they owed an obligation**
 - **Court of Appeal said that insurer's attempt to stack limits was impermissible**



Statute of Limitations

- **Statute of limitations**

- **patent defects**

- **apparent with reasonable inspection**
- **statute of limitations requires claim to be submitted within 2 to 3 years of project completion**

- **latent defects**

- **defect is not apparent by reasonable inspection**
- **more time is allowed to submit a claim, in some cases 10 years after completion (CA). For comparison purposes, AZ is 8 years, and WA is 6 years (confirmed by WA supreme court in September 2001)**



Statues of Limitation and Repose

- **Statute of Limitation**

- **Statutes of Repose**

- ▮ **Greater than 10 years**

- **IA, AL, SC, IN, PA, UT**

- ▮ **10 Years**

- **CA, IL, KS, LA, MD, ME, MI, MO, MT, NC, ND, NE, NJ, NM, NV, OK, RI, SD, TX, WI, WV, WY**

- ▮ **Less than 10 years**

- **AZ, GA, NH, KY, CO, CT, DE, MA, MS, AR, VA, FL, TN, WA**



“Notice and Opportunity to Repair” Legislation

- **Generally provide builder with written notice and description of alleged defects - 90 days before filing lawsuit**
- **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**
 - **specifically, must give written notice to the builder against whom the claim will be made, including a list of defects**
 - **didn't involve subcontractors and wasn't a lawsuit**
 - **does not apply to single family homes**
 - **encourages parties to talk**
 - **final result is that filing of lawsuits gets delayed, increasing lag time**
 - **ineffective**



“Notice and Opportunity to Repair” Legislation (Cont.)

- **California - Steinberg Mandatory Negotiation Bill**
 - ▶ **effective July 1, 2002, amendment to Calderon**
 - ▶ **treat like a suit and bring subcontractors in**
 - ▶ **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**
 - ▶ **a construction defect expert will act as a referee**
 - ▶ **Bill is supported by both builders and attorneys**
 - ▶ **if cases go to trial, courts required to give these cases priority**
 - ▶ **intended to be an improvement over Calderon**



“Notice and Opportunity to Repair” Legislation (Cont.)

- **California Senate Bill 800 (“Fix It” Law) – 2002**
 - **established building standards to govern claims against builders**
 - **established a 10 year statute of limitations**
 - **mandatory pre-lawsuit process**
 - **statutory affirmative defenses**
 - **effective January 2003**
 - **not making much of an impact, not retroactive**



“Notice and Opportunity to Repair” Legislation - Arizona

- **Statutory Pre-Litigation A.R.S. ~33-2002**
 - **HOA Notice to and Meeting with Homeowners**
 - **Tolling of Statute of Limitations**
- **Right to Repair Statute – A.R.S. ~ 12-1361 – 12-1366**
 - **Effective August 22, 2002**
 - **Defines what a homeowner must do prior to commencement of CD litigation**
 - **Status of subcontractors in the process**
 - **Sufficiency of “fix”**
 - **Destructive testing (expert)**
- **Complex Panel**
 - **01/01/03 Maricopa County established a complex division consisting of a three judge panel**



“Notice and Opportunity to Repair” Legislation – Nevada

- **2003 NV legislature passed SB 241 (Replaced SB240)**
 - **details the steps each party must take with respect to complaints of defects**
 - **overall effectiveness undetermined**
 - **subject to judicial interpretation**
 - **Bill did not reduce costs**
 - **availability of coverage continues to decline**
- **NV has changed the statute every two years**



Commonly Alleged Defects - Mold

- **Water damage, mold and construction defects are intricately related**
- **If the mold is caused by excess moisture which was in turn caused by construction defects, the cost to clean up the mold and the cost of repairs to prevent future mold may be covered**
- **Insurance Information Institute* estimates 10,000 mold related lawsuits pending in U.S. - 20% involve construction defect allegations**
- **52 mold related bills introduced in 20 states during 2003 legislative session**
- **Mold allegations being thrown in as “negotiating tool”**



Commonly Alleged Defects - EIFS

- Exterior insulating finishing systems (EIFS)
- Synthetic stucco
- Water gets trapped behind the stucco and rots the frame, plywood, and particle board
- If installed correctly, could be a manageable risk
- In the past, primarily a residential problem; may become a commercial problem in the future: in 1997, EIFS used only on 1.5% of residential, but on 22% of commercial construction; residential failures have not curtailed commercial applications
- Some homebuilders' insurance companies have taken action to exclude EIFS construction from commercial general liability policies; insurers of commercial builders have not taken the same action



Common Exclusionary Endorsements

- **Montrose endorsement**
 - **restricts application of continuous trigger**
 - **exists in various forms; some more effective than others**
- **Known loss provisions**
 - **excludes coverage where insured was aware (ISO/2001)**
 - **some exclusions apply to “known and continuing”**
 - **“deemer” provision - property losses “deemed” to have occurred at a specific time; only one policy can be triggered**
- **EIFS exclusion - appears on EIFS installation contractors and contractors tied to moisture (e.g., roofers, HVAC, plumbers, window installers)**



Common Exclusionary Endorsements (Cont.)

- **Mold exclusions - applies to broad spectrum of contractors (e.g., roofers, HVAC, plumbers, window/sheetrock /siding installers, foundation workers, landscapers)**
- **Earth movement exclusions - applies to contractors working on foundations or grading; applies to earthquake prone areas**
- **Residential construction exclusions - carve out protection on mainly commercial contractors/subcontractors**
- **“Damage to Your Work” exclusion - prevents policy from acting as warranty on insured’s work**
- **Subcontractor exclusion endorsements - can add back in damage caused by subcontractor’s work**



Common Exclusionary Endorsements (Cont.)

- **Additional insured endorsements - adds contractor as an additional insured; questions as to whether applies to completed operations or losses caused by insured's own negligence (pre 1993 - all; post 1993 - "ongoing")**
- **"Other insurance" - if other insurance exists this policy is excess; recent court decision that should be treated as primary**
- **Endorsements generally do not eliminate coverage but rather shift responsibility**



Initial Investigation of a Standard CD Claim

- **Determine facts needed, who would have them, and request them**
- **Project site information – single family home / condominium**
- **Complaint, Cross-complaint, and other pleadings**
- **Insured's job contract(s)**
- **Insured licensed and still in business?**
- **Insured's other job file**
- **Nature of insured's work**
- **Dates worked on & notice of completion dates**
- **Number of homes insured worked on**



Initial Investigation of a Standard CD Claim (Cont.)

- **Number of homes alleging defect/faulty workmanship**
- **Preliminary defects list**
- **Expert's reports**
 - **cost of repair estimates**
- **Photographs or other depictions of work, defect, damage**
- **Breakdown between costs to repair replace insured's own product/work and consequential damage**
- **Other insurance available**
 - **named insured**
 - **additional insured**



Why Are CD Claims So Complicated?

- **Definition**
- **Reporting lag**
- **Statute of limitation (patent vs. latent)**
- **Continuous trigger**
- **Multiple claimants**
- **Multiple defendants**
- **Multiple insurance companies**
- **Litigious environment**
- **Additional insured endorsements**
- **Changes in policy form and introduction of exclusions**
- **Insolvencies**



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

Maturity

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

Accident Date

Coding of CD Claims to Accident Year (Cont.)

- Home built in 1995
- Claim reported in 2002
- Company A sold contractor policy from 1993 through 1998
- Company B sold contractor policy from 1999 through 2002

Accident Date

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

Coding of CD Claims to Accident Year (Cont.)

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

Maturity

Accident Date

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

Coding of CD Claims to Accident Year (Cont.)

- Assume Montrose Endorsement added in 2000, then.....

Maturity

Accident Date

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



Actuarial Analysis - Issues to Address

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

Exposures/Underwriting

- **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**



Actuarial Analysis - 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**



Actuarial Analysis - 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



CD Reserving Methodologies

- **Several methods are typically used to provide an overall picture of the company's reserve exposure and to test sensitivity**
- **For starters, obtain a claim download to facilitate detailed claim analysis**
- **Reserving methods include**
 - **accident year analysis**
 - **report year analysis, including varying runoff claim estimates using multiple claim reporting scenarios**
 - **exposure analysis**
 - **calendar year analysis**
 - **varied loss development approaches using both CD specific and non-CD loss development factors**



Tillinghast's "Best Practice" Method

**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)




Tillinghast's “Best Practice” Method (Cont.)

- **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**
 - **varying claim counts, CWP, and severity**
- **For reasonability check, compare results against other methods used**
- **Can allocate costs back to accident year**



Tillinghast's “Best Practice” Method (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**



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**
 - **changes in claims operations (e.g., movement to specialized units)**
 - **changes in reserving philosophy**
 - **“management’s opinion that future development will be less”**
- **Monitor results using diagnostic testing**
 - **examine closure rates (CWP, CWNP, CWLP, CWAP)**
 - **review reported, paid, outstanding, and ultimate severities**
 - **impact of large claims**



Frequency Method for “Pure” IBNR

- **Estimate future claim counts**
 - **claim count accident year development and Bornhuetter-Ferguson methods**
 - **exposure base emergence**
 - **curve fitting reported to date**



Frequency Method for “Pure” IBNR (Cont.)

- **Claim count accident year development and Bornhuetter-Ferguson methods**
 - **accident year loss development method**
 - **accident year loss development method w/ tempered LDFs**
 - **Bornhuetter-Ferguson method using premium, risk factor, and claim frequency as initial expected claim count**
 - **reasonability check on calendar runoff**



Frequency Method for “Pure” IBNR (Cont.)

- **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**

Frequency Method for “Pure” IBNR (Cont.) – Exposure Based Method – unsophisticated example

Exposure Based Method To Estimate IBNR Claim Counts

Accident Year Earned Exposures

1 10
2 35
3 60
4 80
5 50

		Report Year								
		1	2	3	4	5	6	7	8	9
1	10	10	10	10	10					
2	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



Severity Method for “Pure” IBNR

- **Frequency/Severity Method for “Pure” IBNR (Cont.)**
 - **estimate CWP ratios**
 - **select after reviewing accident year and report year data**
 - **estimate loss and ALAE severities**
 - **using paid on closed claims**
 - **using reported losses and estimated CWP**
 - **make adjustments for large losses**
 - **select trend factor**



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, and WA**
- **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**
- **Better construction**



Other Discussion Items

- **Diminution of value**
- **Product liability**
 - ▶ **defective wood sealant - \$55M judgment against Behr Process Corp**
 - ▶ **defective shingles - \$75M judgment against American Cemwood Corp**
- **Legal malpractice**
- **Bad faith claims and punitive damages**
- **Real estate agents or architects**
- **Fault of inspector/municipality**



Common CD Issues in Litigation (According to Mealey's Litigation Reports)

- **Mold**
- **EIFS**
- **Faulty workmanship/"your work"**
- **Expansive soils**
- **Statute of limitations**
- **Additional insured/duty to indemnify**
- **ARBITRATION**



What the Markets Are Doing?

- **Underwriting rather than rating**
- **Exclusions**
- **Mandatory dispute resolution processes**
- **Warranty packaging**
- **Claims made type policies**
- **CCIPs (Contractor-controlled insurance programs)**
- **Wraps**
- **Captives**
- **SIRs/deductibles**
- **Use of SIRs increasing use of additional insured endorsements**



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