

Appendix A: Insurance Study Overview

The Construction Claims Task Force was created by House Bill 2078, passed during the 2005 session. House Bill 2078 also required the Department of Consumer Business Services to engage a qualified expert to study issues related to affordability and availability of contractor liability insurance.

American Actuarial Consulting Group (AACG) was selected to conduct the study required by House Bill 2078. The study, entitled “Insurance Analysis: Reforms, Alternatives, and Pricing,” is excerpted in this appendix. All of the language in this excerpt is taken directly from the study produced by American Actuarial Consulting Group, with the exception of two notes of clarification included by task force staff.

The full insurance study report is available on the Web at:
<http://egov.oregon.gov/DCBS/CCTF/>. Click on Insurance Study Report.

Introduction

Problem Statement

During the current boom in residential construction, Oregon new housing permits grew from 19,877 in 2000 to 31,864 in 2005. A byproduct of this growth has been an increase in construction defects and a corresponding increase in construction defect liability claims. Responses of some insurance carriers to the heightened level of defect claims have threatened the availability and affordability of liability insurance to contractors. Without liability insurance, contractors cannot obtain a license in Oregon. Liability insurance is also a source of broad protection for both contractors and consumers.

Tasking

Oregon House Bill (“HB”) 2078 established the Construction Claims Task Force. The task force was directed to study the relationship between construction claims and construction industry practices, construction defects, consumer protection, and state-mandated requirements for contractors. The objective of the task force is to reduce the number of construction defects while ensuring appropriate protection of Oregon consumers and affordable insurance for contractors. To support this objective, the task force engaged AACG to study options and make recommendations regarding sound insurance reforms [...] to provide construction contractor insurance required under Oregon Revised Statute (ORS) 701.105. Options are to be evaluated against the broad goal of enhancing the availability and affordability of contractor liability insurance without decreasing consumer protection. This report is provided in response to that charge. It is important to note that a healthy insurance environment actually supports all three aspects of the task force objective. A properly structured insurance program reduces losses, lowers insurance costs, and expands consumer protection. In addition to analyzing each option’s capacity for enhancing the availability and affordability of contractor insurance, the report will also evaluate each option’s potential for reducing losses and broadening consumer protection.

Background

Construction Defects

With all the material written on this subject, it is difficult to find a clear, concise definition of a construction defect. No specific definition exists in statute. The courts have generally determined that any condition that reduces the value of a home or condominium may be defined as a defect in design or construction.

In recent years, the number of defects has been increasing. Although quantification of defects has not been tracked over time, an informal survey of residential inspectors by Consumer Reports indicates that 15 percent of new homes have at least one major defect. If this number is correct, the total number of defects would be increasing just based on the yearly increase in housing starts.

Builders' Warranties

Builders' warranties are generally the first option for repairing construction defects. There are three forms of builders warranties: explicit warranties, implied warranties, and third-party warranties.

Warranty is the most efficient way to provide for the repair of construction defects. It is obviously most effective when the terms of the warranty are clearly understood by both the builder and the homeowner, and the builder honors the terms. In those cases, the builder arranges to have the problems corrected. Time delays as well as costly adjusting and legal expenses are avoided. In cases where builders do not honor the terms but coverage is afforded by a third-party warranty policy, defects are treated much like property damage covered by a homeowner policy. The defect is appraised and repaired. Depending upon the terms of the policy, any damage to the structure caused by the defect may or may not be covered. No legal expense is involved. J.D. Power and Associates conducts a yearly "New Home Builder Customer Satisfaction Survey." In the 2005 survey, 10 factors that drive overall satisfaction with a homebuilder were identified. The number one factor was the builder's warranty. Its factor weight was twice the weight given to price.

Current Remediation Environment

Overview

If Oregon homeowners are unable to achieve satisfaction through warranty, they have three possible avenues for remedy: Surety Bonds, Senate Bill ("SB") 909 Notice of Repair ("NOR") process, and Commercial General Liability Insurance.

Impact of Defect Claims on Availability and Affordability of Commercial Liability Insurance

When courts began to find that the coverage grant of the CGL policy extended to construction defects, the insurance industry was taken by surprise. During the period from 1998 through 2005, loss and claim expense data supplied by 11 insurers offering liability coverage to Oregon contractors indicated that construction defect claims accounted for approximately 46.6 percent of total claim losses and approximately 60.9 percent of total claim settlement expenses. Providing coverage for these defects represented an unintended and unexpected exposure to loss. Insurers' responses to

such unexpected interpretations of their contracts have become predictable. Some insurers simply withdraw from the market. Others dramatically increase premiums, become much more selective in issuing policies, and add endorsements to the policies that restrict the exposure. All of these actions have occurred in Oregon and across the nation, and they have contributed to the “liability insurance crisis.”

Conclusions on Availability and Affordability

Liability insurance is available in Oregon in the admitted market. However, the three surveys lead to the same conclusion. It is available at rates that are significantly higher than rates charged in 2000.

Options Available to Oregon

Overview

Based on the information gathered from other states as well as our current assessment of the market in Oregon, AACG evaluated a number of options as spelled out in the request for proposal dated Nov. 8, 2005. For each option, we analyzed the pros and cons that would be associated with implementing the option in Oregon. We provide discussion about specific considerations unique to each option that should also be considered. As we evaluated each option, we attempted to balance the oftentimes competing goals of promoting availability and affordability of contractor liability insurance in the state while maintaining or strengthening protections for consumers.

Resolving construction defect problems involves repairing or restoring damaged property. Insurance normally provides two policy types to protect property. Property is indirectly protected by liability insurance. Liability insurance directly protects the assets of an individual from unintentional acts of the individual that cause bodily injury to a third party or damage to the property of a third party. Property insurance directly protects property from either a specific list of named perils or from all risks less specific exclusions. No property policy currently provides protection for the peril of construction defects. All insurance options that were evaluated involve potential modifications to liability insurance coverage.

The options that were reviewed fall into three categories: Options to Improve Warranty, Alternative Coverage Mechanisms, and Pricing Options. Within each of the categories, we reviewed multiple options and evaluated them for feasibility within Oregon.

Conclusions

Overview

In the current environment, new homeowners are afforded little guaranteed protection against potential construction defects. If a builder fails to repair damages, the homeowner’s last recourse is to sue the builder for negligence and seek recovery under the builder’s CGL policy. If the homeowner prevails in the suit, only partial recovery is available. The CGL policy pays for repairing damages caused by the defect, but not for repairing the defect itself. Surety bonds are available for repairing the defect, but the size of the bonds may not be sufficient to cover the cost of repairs. In addition, insurers often pay more for legal expenses than for the actual cost of repairing damages.

Any option or set of options selected by Oregon should strive to better define the rights of homeowners and the responsibilities of builders with regard to construction defects that arise after occupancy. Options should also provide an opportunity for reduction in the legal expenses associated with liability settlements. Finally, the options should provide financial incentives that would encourage builders to adopt the best practices recommended by CCB.

Options Evaluated by AACG

The RFP issued under HB 2078 requires that options be evaluated against the broad goal of enhancing the availability and affordability of contractor liability insurance without decreasing consumer protection. Oregon statute ORS 701.105 requires property damage and bodily injury protection for work-in-progress. Although a work-in-progress policy is available in the marketplace, its usage is minimal. Actual consumer protection is defined by the CGL policy, which is the standard in use by contractors. The CGL policy covers both work-in-progress and completed operations. Any option that reduces coverage below that available in the CGL policy actually reduces current consumer protection.

Property insurance provides the most efficient coverage for protecting residences against physical damage. However, no property policy is currently available that protects new residences against the peril construction defect. Since it focuses directly on the repair of damaged property, warranty is a close proxy. First-party warranty and third-party warranty insurance options were evaluated. AACG offers the following comments regarding these options:

- The first-party warranty option would require builders to provide a specific minimum warranty with each new home. Such a requirement would remove the ambiguities and confusion that currently exist with implied warranties. This option could be implemented with little market disruption and no additional policy expense. Effective enforcement is the primary concern with this option.
- The third-party warranty insurance option would require that the mandated minimum warranty be backed by a third-party warranty policy. This requirement would eliminate the enforcement concern. Considerable market disruption could occur with implementation of this option. The cost-benefit analysis that was performed may not justify this disruption. (Note: The option discussed by AACG in this report presumes that a third-party warranty is mandatory. The third-party structural warranty in phase II, recommendation 1 is voluntary to minimize the potential market disruptions discussed in this study.)

Liability insurance offers the only true insurance options. A number of liability options were considered. The following two options held the most promise for improving availability and affordability.

- Policies offered with specific loss control discounts would explicitly tie building practices to insurance costs. The policies would make it apparent to builders the financial benefits of adopting best practices.

- The major friction cost in settling construction defect claims is legal costs. Wrap policies have demonstrated that they significantly reduce these costs. Currently, wrap policies are only available to projects with construction costs exceeding approximately \$90 million. Lowering this minimum could extend potential legal expense savings to a larger number of projects. (Note: The proposal discussed by AACG included “wrap” policies that do include workers’ compensation and policies that do not. After receiving testimony regarding the difficulty of implementing this recommendation for policies that include workers compensation, the task force recommended that phase II, recommendation 3 not apply to policies that include workers’ compensation.)

Data availability was a significant concern during the course of the project. Neither CGL policies nor associated construction defect claims are coded in the insurance companies’ automated systems with the same level of detail found in other lines of business. Participation in the data call often required companies to manually pull information from hard copy files. As a result, both participation in the data call and the data available for analysis were limited. Although the available options would not have changed, additional data could have enabled isolation of the problem areas and allowed for specific application of the options. If the Insurance Division increases future reporting requirements for CGL policies, it could have a positive impact on future availability of data.

Areas for Further Study

The task force directed the Insurance Division to further explore the following five options. These options are consistent with the findings of this report.

1. Change ORS 737.602 to enable projects with constructions costs of \$10 million or more to obtain wrap policies.
2. Allow insurers to offer policies with loss control discounts on a voluntary basis.
3. Change ORS 701.105 to require contractors to carry both work-in-progress and completed operations coverage that would provide coverage for the entire period of the statute of repose.
4. Increase the data reporting requirements associated with CGL policies.
5. Investigate the implementation of an explicit first-party warranty requirement in Oregon for new residential constructions.

Appendix B: List of All Recommendations Received By The Task Force

Construction Claims Task Force Phase I and Phase II Recommendations

Over the course of its work, the task force received recommendations from invited experts as well as the general public. The task force received more than 80 recommendations that have been compiled into a single list below.

Phase I – Construction Issues

At the February 2006 meeting, the task force prioritized recommendations, reducing the list to 20. Staff consolidated similar recommendations into 10 concepts, which the task force further refined into the six final Phase I proposals.

Phase II – Insurance Issues

At the August 2006 meeting, the task force considered a list of six recommendations compiled from expert testimony, public comment, and the insurance study. Through discussion and analysis the task force recommended five final Phase II proposals.

CATEGORY	ALL RECOMMENDATIONS ¹
Design/Construction Practices	
1. Building materials	<ul style="list-style-type: none"> A. Require manufacturers to provide material properties so they can be fed into computer models. B. Identify durability and maintenance characteristics for different wall assemblies and materials given Oregon’s climate zones. C. Develop a test facility to validate computer models and conduct Oregon-specific, building-science research. D. Require manufacturer, material supplier, or building-envelope contractor (e.g., roofing, siding, windows, etc.) to certify that the material application and installation conform to code and manufacturers’ standards. E. Restrict the use of certain building materials based upon Oregon-specific data, contractor’s insurance exclusions, and/or contractual limits on material substitutions.

¹ This list of recommendations represents what industry experts, members of the public, and state agency staff have submitted to the task force. It does not necessarily reflect the opinion of individual task force members.

CATEGORY	ALL RECOMMENDATIONS ¹
2. Design	<ul style="list-style-type: none"> A. Develop minimum, building-envelope design standards including use of a drainage cavity. B. Require greater design detailing on plans as well as mock-ups for sensitive or complex assemblies. C. Increase the amount of building overhangs. D. Involve building-envelope specialists in development process from design through occupancy. E. Require third-party consultant or project architect to sign off on building envelope design. F. Additional training and continuing education requirements for design professionals.
3. Quality assurance/ quality control	<ul style="list-style-type: none"> A. Develop “best practices” and installation guidelines consistent with code and manufacturers’ instructions. B. Encourage field testing of in-place envelope assemblies. C. Encourage greater project documentation that demonstrates an “as built” condition. D. Increase oversight on the job site by architect, engineer, building envelope specialist, or other certified supervisor to review construction practices. E. Require third-party review of design, construction, and/or maintenance. F. Require a certified and trained supervisor to be present at the job site.
4. Training/education	<ul style="list-style-type: none"> A. Provide training related to building-science and water-intrusion issues to designers, contractors, inspectors, and property managers. B. Require continuing education for contractors. C. Require additional business-competency education for contractors. D. Develop standards for contractors to properly train and certify employees. E. Utilize outside groups and manufacturers to provide training and certification; many groups offer such programs.

CATEGORY	ALL RECOMMENDATIONS ¹
Regulatory Environment	
5. Building codes	<ul style="list-style-type: none"> A. Explore rainscreen technology as a construction approach. B. Require additional mechanical venting of moisture from interior spaces (e.g., bathrooms and kitchens). C. Require moisture content not exceed a defined level before closing the cavity. D. Adopt code changes related to type of flashing used. E. Adopt code changes related to concrete and slab-on-grade including proper venting. F. Adopt earthquake base model code without amendment.
6. Consumer education	<ul style="list-style-type: none"> A. Provide consumer education to apartment occupants regarding mold. B. Provide consumer education to owners and homeowner association boards regarding maintenance plan and maintenance issues. C. Require documentation of proper maintenance in order to make defect claim.
7. Insurance/bonding	<ul style="list-style-type: none"> A. Increase bond amount or institute a stratified bond amount based on work volume. B. Require performance bonds when a contractor has a history of claims. C. Create a separate CCB registration process for subcontractors who would remove the requirement for subcontractors to obtain insurance.² D. Clarify Oregon’s “additional named insured” issue. E. Contractors with a history of violations must provide performance bonds. F. Create a warranty requirement (Phase II). G. Require contractor’s general liability coverage to include completed operations coverage (Phase II). H. Lower limits on wrap projects (Phase II). I. Encourage loss control discounts (Phase II). J. Require agent disclosure of market search efforts (Phase II). K. Create a data reporting requirement for insurers to report premium, loss, and other information to Oregon Insurance Division (Phase II).

² In this scenario, all subcontractors would perform work under contract subject to the general contractor’s insurance.

CATEGORY	ALL RECOMMENDATIONS ¹
8. Licensing	<ul style="list-style-type: none"> A. Create a specialized license for building-envelope contractors (e.g. roofing, siding, windows, etc.) to include required training, experience, and/or demonstration of competency. B. License/register building envelope specialists. C. Mandate additional licensing requirements for contractors (e.g., documented experience, proof of code proficiency, construction practices training, continuing education). D. Increase CCB’s enforcement powers including terminating contractors’ licenses, if they have a history of problems (JS, PUB) E. Require contractors to submit a list of employees to CCB including any employee’s previous CCB license number. F. Prevent problem contractors from obtaining a license under a new corporate identity. G. Certify or license the individual tradespersons performing the work; could be performed by contractors.
9. Permits/inspections	<ul style="list-style-type: none"> A. Review building penetration details and building-envelope technology during plan-review process. B. Additional inspection of envelope systems during construction to ensure compliance with design specifications, including and with focus on building envelope. C. Require inspectors to cite code violations that were overlooked during previous inspection(s) or where the work has subsequently been altered. D. Require the contractor doing the work to take out the permit (as opposed to the homeowner). E. Require a “Certificate of Occupancy” for residential construction. F. Require some jurisdictions to submit verification, such as field notes, to prove inspection was performed.

CATEGORY	ALL RECOMMENDATIONS ¹
10. Regulatory framework	<ul style="list-style-type: none"> A. Mandate minimum contract provisions including required disclosure of pertinent information. B. Improve state oversight of local jurisdictions including a state appeals process and audits of inspection practices. C. Eliminate supplier/subcontractor’s ability to place a lien against homeowner’s property for general contractor’s failure to pay. D. Allow complainants to collect attorney fees if their claim prevails. E. Increase public representation and/or oversight on BCD and CCB boards and panels. F. Encourage the governor to appoint a special ombudsman to investigate CCB. G. Mandate use of contract terms that make general contractors legally responsible for the work of their subcontractors. H. Prosecute the most egregious contractors in criminal court. I. Align the statutes of repose for contractors and architects, both should be the same. J. Increased fines levied against builders found in violation of codes. K. Reorganize BCD and CCB in order in order to ensure responsiveness to consumers. L. Institute a “Lemon Law” concept applicable to defects in homebuilding. M. Restrict right to work for contractors with a history of violations. N. Increase period in which individual can bring a claim against a contractor by up to five years. O. Prohibit practice of limiting contractor liability to amount quoted. P. Require contractors to provide a list of employees and all licenses the employees have held; make information available to public.
Dispute resolution	
11. Arbitration/mediation	<ul style="list-style-type: none"> A. Streamline the dispute resolution process to encourage more timely, responsive, and lower-cost settlements. B. Develop a “fix it first” approach that involves all parties (must go beyond current “right to cure”). C. Adopt a system similar to the Arizona model.
12. Complaint process	<ul style="list-style-type: none"> A. Improve public’s ability to review a contractor’s complaint history. B. Extend or remove timelines for filing a complaint with CCB. C. Establish a recovery fund.

CATEGORY	ALL RECOMMENDATIONS ¹
Post-construction	
13. Maintenance	<ul style="list-style-type: none"> A. Develop standardized maintenance schedule. B. Prioritize maintenance plan tasks and develop a standardized log to maintain and organize maintenance plan records. C. Establish adequate maintenance reserves. D. Require HOAs to perform annual inspections. E. Use technology to find best methods to discover and solve building defects. F. Building integrity management should be adopted as a method to ensure proper building and maintenance.
14. Warranties	<ul style="list-style-type: none"> A. Create a mandatory warranty program.

Additional information can be obtained at: <http://egov.oregon.gov/DCBS/CCTF/>.

Appendix C: House Bill 2078 (2005)

73rd OREGON LEGISLATIVE ASSEMBLY--2005 Regular Session

Enrolled House Bill 2078

Ordered printed by the Speaker pursuant to House Rule 12.00A (5). Pre-session filed (at the request of Governor Theodore R. Kulongoski for Construction Contractors Board)

CHAPTER

AN ACT

Relating to construction claims; and declaring an emergency.

Be It Enacted by the People of the State of Oregon:

SECTION 1. (1) There is created the Task Force on Construction Claims consisting of nine members appointed as follows:

(a) The administrative officer of the Construction Contractors Board shall appoint three members:

(A) One of whom must be a contractor licensed under ORS chapter 701 who specializes in the construction of single-family residences;

(B) One of whom must be a general contractor licensed under ORS chapter 701 who specializes in the construction of commercial multifamily structures; and

(C) One of whom must be a general contractor licensed under ORS chapter 701 who specializes in the construction of commercial structures.

(b) The Director of the State Department of Energy shall appoint one member as a representative of the State Department of Energy.

(c) The Director of the Department of Consumer and Business Services shall appoint five members:

(A) One of whom must be a member of the Residential Structures Board;

(B) One of whom must be a person with expertise in residential construction design;

(C) One of whom must be an insurance agent or other person with expertise in the insurance industry who is not affiliated with the construction industry;

(D) One of whom must be a representative of an insurance industry carrier offering insurance of a type required by ORS 701.105; and

(E) One of whom must be a representative of the public.

(2) The task force shall study the relationship between construction claims and construction industry practices, construction defects, consumer protection and state-mandated requirements for contractors. The study shall be designed to produce:

(a) An evaluation of construction claims in Oregon, including but not limited to the causes and extent of construction defects, the availability and affordability of contractor liability insurance and the need for maintaining or increasing consumer protection.

(b) Recommendations regarding construction practice changes to reduce construction claims, such as changes to education, quality control and building code requirements.

(3) In addition to the study results described in subsection (2) of this section, the task force may design the study to produce one or more of the following:

(a) A review of any construction claim reduction actions taken in other states or countries.

(b) Recommendations regarding Oregon construction claims, including but not limited to recommendations concerning construction defects, consumer protection and state-mandated requirements for contractors.

(c) A cost-benefit or other analysis to determine whether current consumer protection laws, building codes and contractor insurance requirements regarding construction claims are adequate and any recommendations for changing those laws, codes or requirements.

(d) Recommendations regarding changes to the inspection of construction materials and construction methods that may reduce the number of construction claims.

(e) Recommendations regarding possible restrictions on construction materials or methods that may reduce the number of construction claims.

(f) A review of the impact of construction warranty use on the filing of construction claims and recommendations regarding construction warranties.

(4) The Director of the Department of Consumer and Business Services shall provide for a professional qualified expert to study options regarding actuarially sound insurance reforms, alternatives and pricing, including loss control discounts or the designation of a single private insurer to provide the construction contractor insurance coverage required under ORS 701.105. The task force shall include any recommendations of the professional qualified expert in the study materials developed by the task force and may include the recommendations in the recommendations for legislation reported by the task force under subsection (11) of this section.

(5) A majority of the members of the task force constitutes a quorum for the transaction of business.

(6) Official action by the task force requires the approval of a majority of the members of the task force.

(7) The task force shall elect one of its members to serve as chairperson.

(8) If there is a vacancy for any cause, the appointing authority shall make an appointment to become immediately effective.

(9) The task force shall meet at times and places specified by the call of the chairperson or of a majority of the members of the task force.

(10) The task force may adopt rules necessary for the operation of the task force.

(11) The task force shall submit a report, and may include recommendations for legislation, regarding construction claims to the Seventy-fourth Legislative Assembly no later than January 31, 2007.

(12) The Construction Contractors Board and the Department of Consumer and Business Services shall provide staff support to the task force pursuant to the interagency agreement described in subsection (15) of this section.

(13) Members of the task force are not entitled to compensation, but may be reimbursed for actual and necessary travel and other expenses incurred by them in the performance of their official duties in the manner and amounts provided for in ORS 292.495. Claims for expenses shall be paid out of funds made available to the Department of Consumer and Business Services for that purpose under the interagency agreement described in subsection (15) of this section.

(14) All agencies of state government, as defined in ORS 174.111, are directed to assist the task force in the performance of its duties and, to the extent permitted by laws relating to confidentiality, to furnish such information and advice as the members of the task force consider necessary to perform their duties.

(15) The Construction Contractors Board and the Department of Consumer and Business Services shall enter into an interagency agreement to coordinate expenditures and staff support to carry out the duties of the task force.

SECTION 2. Section 1 of this 2005 Act is repealed on January 1, 2008.

SECTION 3. This 2005 Act being necessary for the immediate preservation of the public peace, health and safety, an emergency is declared to exist, and this 2005 Act takes effect on its passage.

Passed by House February 2, 2005

Received by Governor:

Repassed by House July 15, 2005

.....M.,....., 2005

Approved:

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Chief Clerk of House

.....M.,....., 2005

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Speaker of House

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Governor

Passed by Senate July 12, 2005

Filed in Office of Secretary of State:

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President of Senate

.....M.,....., 2005

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Secretary of State