



Current Construction Issues In Contractor's Commercial General Liability Insurance Coverage

Key Issue

Contractor's commercial general liability (CGL) insurance coverage is currently in a crisis mode for construction in many areas due to a number of issues. Contractors are seeing significant premium increases for this coverage ranging from as high as 600% to 1,000% on a year-over-year basis in States, such as California and Nevada.

The cost of this insurance is the second highest insurance cost for contractors behind worker's compensation coverage. Moreover, significant policy exclusions are prevalent, including exclusions for project types, such as condominiums, apartments, and master-planned developments that include a homeowner's association.

The increasing prevalence of construction defects lawsuits has led to the exclusion of various exposure types of construction from CGL policies. Constructor education about these emerging CGL trends is essential, since mistakes here can and, in fact, have led to the bankruptcy of contractors and developers.

Introduction

Risk management in construction is a key element in business success and survival for contractors. This risk management can take many forms, including subcontracting to shift risk to others, contract modifications, avoiding extreme-risk projects, subcontractor bonding, and insurance requirements. The last category of insurance includes numerous types of insurance, including worker's compensation, builder's risk, errors and omissions (for design-build responsibilities), and commercial general liability. The focus of this paper will be on current construction issues in contractors' commercial general liability insurance coverage.

Commercial general liability (CGL) policies provide coverage for contractors, arising out of events from their completed construction operations. Thus for a general contractor, a roof leak that damages a two-year old office building, due to an omitted flashing detail by the roofing subcontractor, would have the water damages covered under the CGL policy. An individual contractor's CGL policy will not cover their own defective work, but instead the resultant damage. In the case of a leaking roof, the general contractor's insurance carrier would look to the roofing subcontractor's insurance carrier for compensation for the water damages. The roofing subcontractor would still be responsible to repair, out-of-pocket, the omitted flashing detail.

Similarly, a patron of a restaurant who suffers an injury at the establishment, due to a construction defect, will seek recovery from the restaurant owners, who in turn will claim against the general contractor and subcontractor as well, if relevant. If it was a poorly constructed concrete step at the restaurant by the concrete subcontractor, the ultimate responsibility will be the sub's CGL policy for the personal injury costs and then the sub's own pocket for corrections to the step itself. Thus the standard CGL policy provides for coverage for injuries to persons or damage to property, occurring after a construction operation is completed but attributed to that operation.

Construction defects, resulting in damage to persons or property, are not new. Indeed, some of the world's oldest building codes, such as the Code of Hammurabi in 2200 B.C., prescribed literally "an eye for an eye" punishment for defective construction (Carper, 1974; Kaminetzky, 1992; Poe, 1973). Insurance vehicles, such as builder's risk and worker's compensation, were developed to deal with construction defects, during the time frame of actual construction. The commercial general liability coverages for contractors were developed, as noted before, for problems arising after the completion of construction.

The Changing Environment

Given that both construction defects and commercial liability insurance for them are not new, what are the reasons why contractors must pay close attention to significant changes in the commercial liability insurance environment. In general, the reason for these significant changes in the CGL environment have arisen due to the prevalence of class-action construction defect lawsuits.

Projects, such as condominiums, apartments, and any development with a master-plan format and a homeowners' association, provide a significant opportunity for a plaintiff's attorney in a lawsuit against the project's contractors, if defective construction is present in the project. Flaws in the design, construction, and/or project management on these types of projects contributed to project problems.

As an example, trade interfaces improperly coordinated by the builder, such as the intersection of a balcony deck with an exterior stucco wall result in water damage to interior surfaces. Instead, if the balcony deck-waterproofing contractor would have been scheduled before exterior stucco installation, defect avoidance would be the result. Plans, due to a failure to spend adequate time and funds in the design process, may be unclear as to design requirements. Craft personnel may be unfamiliar with a particular new construction material or existing materials may be used in an improper application. In both cases, missed application steps may take place. The resultant defect may not be apparent, until long after the project construction is completed.

In a 200 or 300 unit condominium project, an investment by every condo owner of \$500 results in a starting legal fund of \$100,000 or \$150,000, respectively. Or an attorney may decide to take the case on a contingency basis for a 40% contingent fee of any recovery. The successful litigation case awards can be substantial.

In one recent 2002 condominium defect case in Nevada, a jury awarded \$12 million dollars on a project whose initial construction costs were \$8 million. The condominium owners' plaintiff's attorneys are now seeking an additional \$8.9 million in legal fees (Hill, 2002). The legal fees are more than the original cost of construction twelve years earlier. In some areas, the vast majority of projects such as condominiums, have ended up in litigation especially in the case of San Diego County in California, where over 90% of these projects have seen construction defect litigation (Luhr, 1998).

Due to the increasing trends towards more construction defect litigation and the rising costs associated with these cases, insurance organizations have been beset by claims. Their reaction has been to substantially change their past approach to commercial general liability policies in the construction arena. Combined with this have been substantial premium increases in some cases on the order of 600% to 1000% (Colvin, 2002).

Insurance Firm Solvency

In discussing commercial general liability insurance concerns for contractors, every contractor purchasing insurance coverage must pay attention to the issue of insurer solvency. Insurance firms make money from both the premium income they receive and the investment income based on the net return of those investments. The success of an insurance company will be measured by its combined ratio, which is the total of two ratios: the loss ratio and the expense ratio. The loss ratio measures the ratio of adjusting costs and losses against the amount of premiums earned. The expense ratio measures the ratio of incurred business operations costs versus written premiums. These two ratios are then added together to measure the combined ratio (Mehr, 1992). If the combined ratio exceeds 100% in any given year, the insurer has then lost money for the year. A.M. Best, a national rating firm, measures the financial solvency of insurers. Six ratings of liability insurers are used, ranging from A+ and A (excellent) to C (fair). If the insurer does not cooperate or does not have a five-year history, the rating is omitted from Best's Report.

Contractors concerned about insurance firm solvency typically place their policies only with insurance firms that have an A+ or A excellent rating (Koehler, 1998). With increasing losses suffered through successful construction defects jury verdicts and out-of-court settlements, insurance firm solvency is a major consideration. In some insurance markets hard hit by losses related to CGL policies, a contractor may face limited options and be forced to place insurance business with a lower-rated carrier. As an example, in the State of Nevada, 70% of the firms previously writing CGL policies for the construction market have exited that market (Royal, 2002).

Admitted Versus Non-Admitted Insurance Carriers

States allow insurance carriers to conduct business within the state. There are two basic classes of insurance carriers: admitted and non-admitted. Admitted carriers are considered residents within that state. Non-admitted carriers are not considered as resident and thus not subject to the same requirements of that state. The common benefit of admitted insurance carriers within a state is priority in terms of receiving insurance business. In the State of Nevada, for example, an insurance agent must go to at least two admitted carriers and receive denials of insurance interest before going out of state (Royal, 2002). Once these two denials are received, the agent can seek insurance coverage anywhere in the world.

In return for the above-cited right of first refusal, admitted insurance carriers within a state pay into an insurance risk pool fund. The purpose of this risk pool fund is to provide compensation for claims, if a particular insurance firm goes out of business. Thus contractors doing business through admitted carriers can be assured that they have a safety net in case their insurer goes bankrupt. On the other hand, non-admitted carriers doing business within a state do not pay into an insurance risk pool fund. Thus a non-admitted carrier that goes out of business may leave stranded a contractor confronting a sizeable construction claim.

Three insurance markets hard hit by construction defect claims, California, Nevada, and Arizona have seen no admitted carriers writing CGL policies in these states in the most current three-year period (Marshburn, 2002). Thus contractors have to figuratively “walk the plank” when placing insurance business with a non-admitted carrier. To protect themselves some contractors and developers are forming limited liability companies with the life of a single project. Every project, thus, has its own unique contracting entities, formed solely for that project.

Claims-Made vs. Occurrence Policy Type Exclusions

An important distinction with CGL policies is when the claim is filed versus when the CGL policy was in effect. Many contractors are unaware of the ramifications of this distinction, when purchasing insurance. Thus contractors may sincerely believe that since they have always had CGL insurance, they are covered from any claim. Nothing could be further from the truth, though, and contractors must understand this key insurance difference.

CGL policies are written either on a claims-made basis or an occurrence basis. Claims-made refers to the fact that the policy only covers claims made on the insurance policy during the policy period. Occurrence refers to the fact that the policy covers claims made on the insurance policy from events occurring during the policy period irrespective of when the claim is filed on the policy (Mehr, 1992).

The distinction is not important with many policies, such as a contractor’s equipment insurance policy, since claims will be filed while the policy is in effect. However, a contractor may be faced with a claim on a project several years after construction completion. Thus the occurrence policy provides important coverage for hidden or latent construction defects.

The difficulty facing many contractors is that they typically may not stick exclusively with one insurance carrier for work over a five to ten-year period. Yet under most state laws, contractors are often responsible for their work up to ten years or more. A contractor switching from one carrier to another may also be changing policy types from a claims-made to an occurrence policy. Thus the contractor may be confronted with a gap in insurance coverage and hence no coverage for the defect claim. A “tail” may need to be purchased for the policy as a supplement to cover potential claims on past work.

Contractor-Type And Project-Type Exclusions

Contractors with the largest exposure in many of these construction defect lawsuits include those in critical trades, for example earthwork/grading, framing, and exterior stucco finishes. As a consequence, many of these contractors cannot obtain CGL insurance at any cost, due to their particular at-risk specialty trade. This failure to obtain coverage may be related to the type of project as well. Thus a wood-framing contractor may be able to obtain insurance for a framing project on a light-commercial strip shopping center, but not for a residential apartment complex.

Project-type exclusions typically manifest themselves in prohibitions for coverage on condominium projects. This is due to the ready potential for class-action lawsuits on condominiums particularly as it relates to common-area construction. Since a condo project's common areas include foundations, roof, area-separation walls, area-separation floors and other elements, there are numerous avenues in a class-action lawsuit.

Since its inception, condominium exclusions have been broadened to include apartments, as well as single-family residential homeowner's association projects. The rationale for the apartment inclusion is that these types of projects can and are converted to condominium projects. An apartment-condo conversion project now means that warranties with the sale of real property start to take effect over the rented premises previous situation.

In some cases, the exclusion may be all residential construction of any variety. As an example, one plumbing contractor, on a mixed-use retail commercial project with sixty apartments built above the retail-shopping promenade, could not obtain insurance because the insurer considered this to be a residential project (Kerzetski, 2002).

Building Materials Type Exclusions

Related to contractor and project-type exclusions are policy exclusions, based on the use of certain high-risk building materials. Certain building materials exclusions, such as asbestos exclusions have been common for a number of years. However, other building materials are seeing increasing reference as sources of exclusions in policies. Some of these examples include EFIS (exterior finish and insulation systems) and polybutyl piping.

Materials, such as polybutyl piping are no longer being used, but a contractor who installed it on a past project may not have coverage, since it has been written as an exclusion to the claims-made coverages described earlier. As one of this writer's late instructors once stated, "There are no bad materials just bad materials applications" (Poe, 1973).

In some cases, the problem is not with the material, but with the application of that particular material. Contractors should be cognizant of repeated materials problems in similar applications. In the case of building material exclusions, written definitions should be sought from the insurer explaining the scope of the relevant exclusion. For example, what exactly is an EFIS application? Does the EFIS application mean any exterior system that utilizes foam insulation? These issues can be exceedingly complex.

Damage Type Exclusions

Pollution exclusions have been common exceptions to coverage in CGL policies for a number of years. An increasing problem in construction has been the prevalence of mold litigation. In Houston, there are currently over 25,000 cases pending related to mold damage (Nazoff, 2001).

Insurers have been unsuccessful in their attempts to avoid mold damage coverage under the pollution exclusion. What has taken place is that newly-issued CGL coverages are specifically excluding mold as a covered issue. One insurer had so few mold claims and in such minor amounts in 1999 that mold cases were not even tracked separately. Now the value of their mold claims exceeds claim values from all other causes (Dolnick, 2002).

The other side of the insurance market for most mold cases is coverage through the owner's property insurance policy. However, property insurance carriers have also seen mold claims skyrocket over the last few years and as a result have been steadily adding this as an exclusion to new policies and coverage renewals going forward.

Contractors in trades, such as exterior stucco, roofing, and plumbing, are having difficulty thus being covered for the key damage area of mold problems related to their work. Insurance carriers still providing mold coverage for contractors are doing so only if the contractor can demonstrate that an aggressive risk management program is in place. Risk management is covered in more detail in due course.

Defense Cost Exclusions

Given that any litigation is expensive, many CGL carriers, in an effort to control their exposure, are excluding defense costs from policies. On a 200-unit condominium project, subcontractors being sued can expect to spend anywhere from \$3,000 to \$5,000 per month defending themselves over the 18-month to 24-month time frame of active litigation on this case (Rasmussen, 2002).

Thus defense costs are subject to a number of exclusions. An insurer may state in the policy that they have “the right, but not the obligation to defend” the contractor. Or it may simply state that the contractor will bear all defense costs for the insurer’s attorneys in defending a CGL claim.

A third type of defense costs exclusion is where a successful judgment is obtained against the CGL carrier that may exceed coverage limits. The CGL policy may state that defense costs are within the policy limits and thereby act as a deductible on the amount of the award.

Increasing Deductible Limits

In another effort to control claims costs, CGL carriers are rapidly increasing deductible limits on new policies. CGL deductibles have moved from relatively minor sums of \$5,000 to \$10,000 to current levels seen in some instances of \$25,000 to \$75,000. One Arizona-based residential roofing contractor, with multi-state operations, has a current deductible of \$75,000 in one state and is paying CGL premiums of \$1,000,000 per year (Colvin, 2002). Another Nevada-based residential concrete slab foundation and exterior flatwork contractor pays \$1,000,000 in CGL premiums, with a \$25,000 deductible limit. In both cases for the Nevada and Arizona contractors, the deductible is on a per occurrence basis.

Thus a 200- unit condominium project that results in a successful damage claim against a roofing contractor of \$5,000 per unit average or \$1,000,000 total. Given the previously cited \$75,000 per occurrence deductible, none of these costs would be covered. With a 5% net margin before taxes, the roofing contractor would have to do \$20,000,000 in additional work to make up for this single claim. Deductibles in some instances have reached as high as \$100,000 per house (Royal, 2002). Previously deductible limits considered an entire project as one claim. As aforementioned, deductibles have increased greatly.

The same can apply to defense costs, which may also be subject to a per unit or per occurrence basis applied above in the case of standard coverage deductibles. Deductibles may cover defense costs, but only after a \$25,000 or more deductible limit is reached. A contractor sued on 5 separate projects or five units in an industrial park may end up paying \$125,000 in defense costs, rather than just a \$25,000 deductible.

Owner-Controlled Insurance Programs

Given that subcontractors in certain specialty areas cannot obtain insurance at any cost, some developers are migrating towards owner-controlled insurance programs (OCIP), to handle insurance requirements. The original goal of OCIPs was to lower the overall insurance costs on a project. Instead of every contractor purchasing separate liability, equipment, worker’s compensation and other project policies; substituted is one master or “wrap-up” policy.

This “wrap-up” policy would be purchased to cover all construction activities during the project or subsequent to construction in the case of CGL coverage issues. On a large project, the economies of scale in purchasing a significant amount of insurance become substantial. Therefore, large owners and large managing/prime contractors were able to effect significant savings.

In the case of large manufacturers, their pickup of construction contractors worker’s compensation costs was taken and blended into the manufacturer’s own experience modification rating (EMR) (Stoddart, 1993). The manufacturer’s EMR was significantly lower than the typical construction firm EMR and in combination with risk management, contractor oversight produced significant overall project savings.

OCIP's, developed to handle CGL issues are a relatively new development on the construction insurance scene. They have been implemented on certain construction projects, such as condominium developments. This is because contractors in high-litigation prone areas, such as earthwork/grading, framing, and stucco, could not obtain insurance coverage at any price for the project. Thus the project developer is faced with canceling the project and building something else or having contractors "going bare," without insurance in those particular subtrades.

The alternative of building something else, on the part of the developer, may not be practical because high land costs dictate multi-family developments, and zoning precludes retail or office uses. The risk of having subtrades going bare without insurance is equally unpalatable. The solution to this insurance problem is for one, unified CGL OCIP policy that covers the entire project.

Both the insurance firm and the developer benefit from an OCIP policy. The unified OCIP means that high-risk and low-risk subtrades will be covered by one blanket policy. Thus the insurance firm obtains a blended risk exposure, as opposed to sole coverage of a high-risk subtrade. If the project does end up in litigation, there will be one set of experts and one set of attorneys representing all contractors on the project for the defense. The unified group of construction experts and attorneys has obvious benefits from an avoidance-of-duplication effort perspective.

Perhaps a more important but more subtle distinction is that the insurance company will not have to contend with contractors' experts contradicting each other and pointing fingers at each other to deflect blame, depending on what contractor these experts represent. CGL OCIP costs for a wrap-up policy, on a recent 100-unit condominium project, were \$250,000 or \$2500 per unit (Legarza, 2002).

Despite the advantages of an OCIP, there is one major disadvantage. If the insurance carrier for the OCIP goes out of business and is not an admitted carrier in that state, now the entire project is without insurance coverage. Without viable insurance coverage in place, aggressive plaintiff's lawyers for a condominium development or home owner's association-type project may decide to seek compensation out of the business and personal assets of the contractors.

Risk Management Program Existence

Last in this paper, but of perhaps most significance in the CGL arena, is risk management for the contractor. CGL carriers are increasingly looking to only cover contractors who are taking a professional approach to their construction site activities. Part of this professional approach includes a strong risk-management program.

While there are many facets to risk management, insurers are examining contractors for CGL coverage based on the following key characteristics:

- 1.) Quality detailed plans and specifications are necessary to communicate design intent to construction personnel in the field. Sometimes, these failure-avoidance steps involve extra steps or modified construction methods and materials to avoid future problems with value engineering in the design stage. As an example, one condominium developer, due to window/flashing water intrusion issues went to a substantially more expensive primary flashing material.
- 2.) Adequate geotechnical site investigations should take place to pinpoint and to address soils problems, such as chemically "hot" soils, collapsible soils, expansive clays, and other soils issues that can affect construction performance.
- 3.) Does the contractor build quality construction? Building quality in the completed construction product is the first step towards avoiding losses on a CGL exposure. While few contractors would admit to poor quality construction, what the contractor does to ensure quality construction must be able to be demonstrated.

- Since many developers do not self-perform any work themselves, the efforts for quality construction will come from their field project management and the quality of subcontractors whom they select. Are subcontractors selected merely on the basis of lowest bid or do quality considerations enter the equation as a key element? Does the contractor require training and education and do the contractor actually do this or merely pay lip service to it?
- 4.) Third-party inspections, during critical construction procedures such as earthwork/grading, framing and roofing, can provide assurance that quality construction practices are indeed taking place and that design intent is not subverted.
 - 5.) Strong documentation practices must be implemented, including photographs and bar coding key construction assemblies. Some contractors in residential construction are going so far as to bar code and photograph all critical construction assemblies, such as shear walls (McConnell, 2001).
 - 6.) Responsive customer service programs that actually fix construction problems in a timely manner rather than ignoring consumer complaints can cut down on defects lawsuits.

Summary

Commercial general liability insurance is a protective measure to reduce a contractor's exposure to losses from completed construction projects. Construction projects are beset in many areas by ever-increasing amounts of construction litigation. Often, this construction litigation has involved contractor coverages under their commercial general liability policies.

As a result of costly litigation and substantial claim settlements, insurance carriers have enacted substantial changes in their CGL coverages. At its most extreme, contractors may not be able to obtain coverages for some types of projects at all. Besides project exclusions, other evolving exclusions prohibit coverage for certain materials, and damages or deductible exclusions are significantly higher, ranging as high as \$100,000 per house. Constructors must be aware of these issues and changes in CGL coverages, to avoid financial disaster.

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