

# Construction Defect Exposures

## Midwest Actuarial Forum – March 2002



Ted Wagner, FCAS, MAAA  
(312) 298-3866  
[edward.h.wagner@us.pwcglobal.com](mailto:edward.h.wagner@us.pwcglobal.com)

# Contents

Background

Remediation Efforts

Reserving Methodologies

Other Issues / Looking Forward

Background

# California Population Growth and Housing Supply Shortage

- In the late 70s through the 80s and early 90s, California experienced unprecedented population and housing growth
- CA population growth doubled the US population growth in many periods
- Demand for housing exceeded supply
- Builders stepped up production
  - Unskilled construction labor
  - “cut corners”
  - Less supervision
  - Cheaper materials

# Litigation Ensues

- Aggressive plaintiff's bar
- Success in early suits fund additional suits
- Unfavorable legal decisions (discussed later)
- Homeowners associations fuel fire
- Construction of multifamily units (condos, townhomes) encourages large cases

# The Montrose Decisions

- I - Montrose Chemical Corp v. Superior Court (Canadian Universal Ins Co) 1993
  - An insurer must defend 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

# The Montrose Decision - 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
  - Stacking of limits; increased severity
  - Multiple carriers on many claims
  - Significant claim count increases

# 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
- Every insurer codes claims differently
  - 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



# Statute of Limitations?

- Patent Defects
  - Apparent with reasonable inspection
  - Statute of Limitations requires claim to be submitted within x years of project completion (usually short, e.g. 2 or 3 years)
- 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)

# Why are CD claims so complicated?

- Reporting Lag
- Multiple claimants
- Multiple defendants
- Multiple insurance companies
- Litigious environment

# Major Exposed Classes of Business

- Real estate managers
- General contractors
- Sub-contractors
- Owners and developers
- Architects and engineers
- Manufacturers of construction and building products-roofing materials, plumbing systems, windows and doors, drywall, stucco and siding

# CD Most Commonly Alleged Defects

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

# Construction Defect Timeline – California

- I Montrose Chemical Corp v. Superior Court (Canadian Universal Ins Co) – Insurer must defend if complaint alleges property damage



- In the 80s and early 90s, population growth, a housing boom and unskilled labor contributed to defective construction

- II Montrose Chemical Corp v. Admiral Insurance – Continuous Trigger and known losses covered

- Stonewall Ins Co v. City of Palos Verdes Estates – Applies Montrose to Construction Defect

# Remediation Efforts

# Reducing Exposures

- Many carriers exited the market completely in the mid 1990s, attempting to “stop the bleeding”
- 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

# Changing the Indemnity Provision of the Construction Contract

- There are three types of indemnity provisions. Moving from type I to type III can reduce your exposure to additional insured claims
  - Type I: Allows for indemnification of GC's negligence, as long as the GC is not solely negligent
  - Type II: Allows for indemnification of GC's passive negligence, but not active negligence
  - Type III: Does not allow for indemnification if GC was in any way negligent



# Calderon Act - 1997, Civil Code §1375

- 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
- Does not apply to single family homes
- Encourages parties to talk
- Final result is that filing of lawsuits gets delayed, increasing lag time

# Reducing Claims Costs

- Centralized claim handling
- Repair and restore versus cash payment settlements
- Joint defense arrangements and common issue discovery
- Insurer cost-sharing
- Policy defenses
- Risk transfer-additional insured (AI) endorsements, indemnity agreements, and hold harmless clauses
- Early involvement of technical experts to evaluate liability

# 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)
- 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

# Construction Defect Timeline – California

- I Montrose Chemical Corp v. Superior Court (Canadian Universal Ins Co) – Insurer must defend if complaint alleges property damage



Pre Montrose

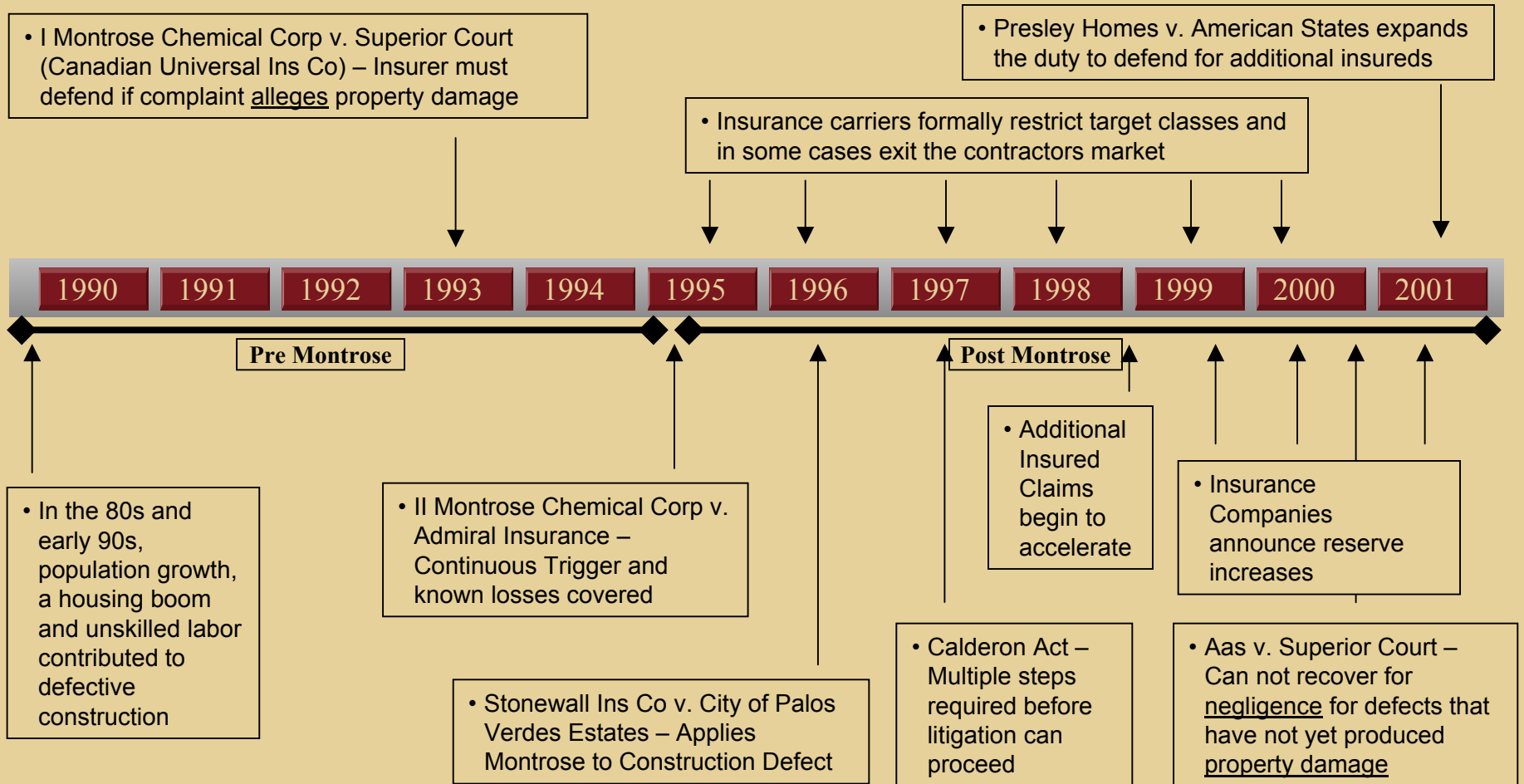
Post Montrose

- In the 80s and early 90s, population growth, a housing boom and unskilled labor contributed to defective construction

- II Montrose Chemical Corp v. Admiral Insurance – Continuous Trigger and known losses covered

- Stonewall Ins Co v. City of Palos Verdes Estates – Applies Montrose to Construction Defect

# Construction Defect Timeline – California



# Reserving Methodologies

# Issues to Address

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

## **Exposures / Underwriting**

- Developer/Contractor vs. Subs/Artisans
- By state and policy year
- Changes in mix by SIC code, class etc.
- Primary and/or excess

## **Coding / Availability of Data**

- By report year, policy year and accident year
- Multiple policy triggers / limits / reinsurance
- Identifiers for CD claims and sub-classes
- Exposures in addition to premium

## **Claim Adjusting / LAE**

- Centralized or distributed
- Factor or average reserves
- Claim denials, incident reports
- Litigation expense treatment
- LAE inclusion in reinsurance

## **Mitigation Efforts**

- Montrose endorsement
- Litigation expense management
- Claim denials / refusals to defend
- Statute of limitations
- Underwriting changes

# 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



# Accident Year Methods

- OK to consider as a starting point . . . After all, you'll need to establish reserves by accident year sooner or later for financial reporting purposes. Perhaps a BF with a really high a-priori.
- Problems with the method
  - Do the accident date and the age of the accident relate to the current incurred and the ultimate value?
  - What does accident date mean in a continuous trigger (Montrose) environment?
  - How do you pick the tail?
  - Calendar Year effects along the diagonal?

# Report Year Methods

- Organize losses and claim count triangles by report year
- Develop Incurred But Not Enough Reported (IBNER) reserve for claims that have already been reported
- Estimate claims to be reported going forward
  - survival ratio
  - curve fit
  - decay assumption
- Perform frequency/severity analysis on true Incurred But Not Yet Reported (IBNYR) claims

# Report Year Methods (Cont.)

- Provide visibility to the practical effect of varying assumptions:
  - Decay Ratios by Accident Year
  - Severities
  - AY groupings
  - CY Trend for severity, or perhaps flat for change in mix (more additional insured claims which are smaller)
  - CWOP ratios, acceleration
- Final result can provide reserves by accident year as well as report year

# Exposure Methods

- Similar to EIL or Asbestos Models
- Develop a list of potential claimants - e.g. construction projects in a particular state
- Compare internal claims activity to the list of projects to determine current penetration
- Project future penetration either through extrapolation or market share analysis

# Other Methods

- Calendar Year Approach
  - Use cumulative paid or incurred by report year
  - Match implied LDF pattern to an industry source (e.g. AM Best GL Occurrence Factors)
  - Assumes a runoff scenario
- Combined
  - By accident year, apply regular GL LDFs to total losses
  - Add additional IBNR for CD Exposure (using frequency / severity approach)

# Other Issues / Looking Forward

# Trends

- Frequency
  - We saw stabilizing frequencies in 1999, 2000 and again in 2001. Although it's mixed, in some cases, we did see decreases beginning in 2001
- Severity
  - Fairly consistent from year to year, but varies widely by company and mix of business
- New States
  - Activity is moving from CA to AZ, NV, NM, WY, CO TX, WA and FL.

# Steinberg Mandatory Negotiation Bill

- Effective July 1, 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
- 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



# 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
- Construction Defect claims are currently property damage claims, but addition of mold could lead to bodily injury claims
- However, the standard pollution exclusion is currently being used to avoid bodily injury claims
- Currently focused on personal lines

# EIFS

- Exterior Insulating Finishing Systems (EIFS)
- Synthetic Stucco
- Water gets trapped behind the stucco and rots the frame, plywood, & 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

# Useful Websites

- <http://www.constructiondefects.com/condef/2ml.listdefects.html> - CD Plaintiff Attorney's Web Site
- <http://www.amre.com/content/rl/constructiondefects/constdefect.html> - American Re Construction Defect Claims and Litigation Guide
- [http://www.crisk.com/Construction\\_Risk/CD\\_Problem\\_Areas\\_01.htm](http://www.crisk.com/Construction_Risk/CD_Problem_Areas_01.htm)
- [http://www.nahb.com/housing\\_issues/eifs.htm](http://www.nahb.com/housing_issues/eifs.htm) - Good Basic EIFS info
- <http://www.eifsfacts.com/> Basic - Description of the EIFS product.
- <http://www.stuccolaw.com/> - EIFS Plaintiff Attorney's Web site

This document contains information that is confidential to PricewaterhouseCoopers, which shall not be disclosed outside the recipient's company or employees and may not be duplicated, stored electronically, used or disclosed in whole or in part by the recipient for any purpose other than to evaluate this material. The material and related discussions shall not be disclosed to any unauthorized user including, but not limited to any consultant, advisor, auditor, contractor, temporary employee, firm, academic or professional organization. Any other use or disclosure in whole or in part of this information without the expressed written permission of PricewaterhouseCoopers is prohibited.

# PRICEWATERHOUSECOOPERS

Your worlds



Our people