

# Blueprint

# Willis

Issue 1

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There is a lot to say about construction risks right now. And while our business is built on one-to-one communication with our clients, the pace of change and news in the world today requires more than one way to keep in touch. With that in mind we introduce *Blueprint*, a new publication from the Willis Construction Practice.

As the leading construction broker in the world, we spend half our time talking to our clients with the goal of fully understanding their risk needs, and the other half finding innovative, cost-efficient, highly tailored ways to help them best meet those needs. We bring to that dialogue, to our problem-solving and to our negotiations with the market a huge and constantly growing wealth of knowledge. The goal of this newsletter is to make some of that knowledge more readily available to our clients, helping to increase their understanding of current risk management issues and generate future conversations with us that will enable us to improve our services to them.

The featured article in this issue is our market update for residential/habitational risks. We also offer an excerpt of our construction market Property and Casualty update published in February. Two regular features of our newsletter we hope you'll find of interest are *At the Bar*, a review of current court cases relevant to the construction risk industry, and *Cornerstones*, a brief profile of a member of the Construction team. I'll also take this opportunity to mention that the annual Willis Construction Conference is just a few weeks away – you'll find more details below.

We hope you find *Blueprint* timely, informative and useful. We welcome your comments, questions and suggestions for future articles.

*Paul Becker, President  
Willis North America Construction Practice*

## Residential Market Update 2007

Every industry has its cycles. The construction and insurance industries follow their patterns – as do the various sectors within those industries. It is the interaction of these forces that creates the dynamic and complex marketplace that risk managers face every day. For example: construction remains down for single family homes and attached

products such as condominiums, while risk transfer capacity for residential builders is now available and overall insurance rates are easing. In the mixed-use development sector, we see continued acceleration in certain areas of the country coupled with a relatively positive underwriting environment. In this residential market update for 2007, we examine in detail the Liability market for homebuilders, condo projects and mixed-use developments.



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## The Liability Marketplace: Homebuilders

The greatest concerns of underwriters in this segment rest with the General Liability policy (a standard ISO form), which traditionally covered defense costs outside the limit of insurance. Beginning a decade ago, underwriters experienced significant losses due primarily to class action litigation for construction defect losses. Insurance policies were being expanded to cover risks beyond what carriers thought they had underwritten and priced, as General Liability policies were triggered to cover defense costs. With litigation increasing and the housing boom continuing, underwriters either exited the US Liability market for residential construction or redesigned their insurance products to address the risk in a different manner.



By 2001, insurance products for homebuilders were changing to either large retention programs with only catastrophic Liability coverage available or, in at least one case, to a General Liability policy with a warranty component to help manage construction defect loss exposures. The insurance market for homebuilders remains fundamentally changed. Despite what risk managers and buyers may have wished, the traditional ISO General Liability form did not return. The market, however, is not stagnant – pricing fluctuates, and there is flexibility around terms and conditions. At the same time, the market has stabilized. The insurers remain few but committed, the products are now familiar, and the risk management process for managing residential exposures, including the use of third-party quality assurance firms, is well established.

Large, high-production homebuilders have General Liability programs that usually include multimillion dollar self-insured retentions. Most builders also employ a General Liability wrap-up program for their West Coast subcontractor exposures. The Liability risk transfer market for trade contractors, especially out west, has not improved; subcontractors likely have little or no coverage for their completed operations exposures (i.e., construction defect exposure). In most cases in California, the

subcontractors cannot work for homebuilders unless a Liability wrap-up is in place. Workers' Compensation is usually not included in these wrap programs.

The market, however, is not stagnant – pricing fluctuates, and there is flexibility around terms and conditions.

### Key Issues Going Forward

- Build up of large dollar sums in captives
- Builders Risk pricing and the backlog of unsold homes
- Carriers' responsiveness to builders seeking new ideas

In most cases, large homebuilders have put away millions of dollars into captive insurance companies to fund their retentions, both on their practice policy and on their General Liability wrap-ups for subcontractor exposures. These funds have built up for the past several years, but for the most part losses have not developed. The challenge for these builders is to determine when and how to bring that money back into the company. An in-depth discussion with alternative risk funding professionals and tax consultants is imperative for these builders. This is good news, but the task is not simple.

Some homebuilders are sitting on large inventories of unsold homes; though this is not a General Liability issue, it is worth noting. These builders must decide how to manage and price that risk in the long period between construction completion and close of escrow. Many of these homes have shelf lives of nine to 12 months. Some builders have considered moving the inventory off of their Builders Risk program and onto their permanent Property program. While there is usually coverage under the Builders Risk program for this inventory, the rates are usually lower for the completed work on the permanent Property program. The concern, however, in this approach is the difficulty in tracking and documenting where the houses are covered. Unless the builder has a solid tracking system, mistakes or inaccuracies could lead to homes being left uncovered. A secondary concern is the risk of a time-consuming conflict with the insurer over where the homes should be covered. This approach is not generally recommended.

Given that the Liability insurance market for homebuilders has stabilized, builders are seeking new ideas from both their insurance brokers and carriers. Areas of interest include improved



internal processes within their risk management departments and programs, the use of alternative funding arrangements (e.g., captives) for new risks, and fresh capacity or product development. Underwriters are often not as responsive as buyers might like and they seem to be putting their creativity into the next crisis or the next trend in construction, such as PPP/PFI business models (private/public partnerships). Underwriters are not creating new products, *per se*, for homebuilders. We *can* expect new or additional capacity, however, during 2007, especially from the London and European markets.



One cautionary note, however. While capacity is available and products familiar, the downturn and financial condition of the housing industry are not lost on the underwriting community. At renewal, buyers should expect requests for more and detailed company information regarding growth, inventory, downsizing, merger and acquisition activity and commitment to risk management processes and procedures.

### The Liability Marketplace: Condo Projects

Condominium project development exploded immediately after the homebuilder Liability crisis that began in earnest in 2001. Since then, condos have consumed the time and interest of builders/developers (including homebuilders in many cases), underwriters and insurance brokers. The condo craze has settled down in many areas of the country with projects being cancelled or “flipped” to rental properties. This cycle is similar to the 1980s condo boom, with overbuilding, cancellations and flipping of projects. Liability insurance has been much harder to come by (and much more expensive) in the current cycle.

The good news for 2007 is that General Liability products do exist for condo projects and their pricing actually has moderated and in some cases dropped by 20 to 30 percent. Terms and conditions remain contentious, particularly defense coverage within the limit of liability.

In response to the boom in condo projects, nonstandard excess and surplus lines (E&S) insurers stepped up to the plate and provided the now familiar General Liability-only wrap-up. Previously, such products were expensive and only offered by a handful of markets. While the new E&S products provided completed operations coverage usually to the statute of repose or 10 years, due diligence was in order because many of the carriers entered and exited the market on a regular basis. As non-standard carriers, they are not regulated by state insurance departments and not backed by state guarantee funds. Further, the need for long-tail coverage in litigious states and the rise in class action lawsuits by condo associations underscored the need to ferret out the carriers that might not be financially sound in the long run.

One cautionary note, however. While capacity is available and products familiar, the downturn and financial condition of the housing industry are not lost on the underwriting community.

E&S products were not the only choice. A large contractor with a standard market construction underwriter might have gotten an accommodation from their underwriter and obtained a stand-alone, General Liability-only wrap-up. In many cases, the standard markets were providing these products with the defense costs outside the limit of insurance. This clearly was a better answer than that provided by the E&S market. The great bulk of the condo business, however, ended up in the E&S market.

#### Key Issues Going Forward

- Excess-of-wrap coverage in builders’ primary/master General Liability coverage forms
- Allocation of costs among subcontractors
- Development of condominium documents to appropriately address risk allocation
- Quality assurance processes

In many cases, the standard insurance markets that underwrite contractors are increasingly becoming restrictive in providing excess-



of-wrap coverage and limits within builders' master General Liability forms. This endorsement was rather easy to obtain prior to the growth in the number of condos. Underwriters' concerns include the fact that most of the General Liability-only wrap-ups are in the non-standard market and have coverage out to the statute of repose (or 10 years). Further, the coverage within those non-standard wrap-up forms is more restrictive than that usually found in contractors' General Liability master programs. If this excess-of-wrap coverage and limit is provided, it is usually done so at a higher attachment point (e.g., the endorsement only applies excess of some underlying per-project limit on the wrap-up) or if the projects and their non-standard wrap-ups are individually underwritten and endorsed onto the master General Liability policy.

Another issue many builders have faced with the condo Liability wrap-up policies is how best to allocate insurance costs and retentions. In some cases, the cost of the Liability and excess insurance for condo projects represents some 10 percent or greater of the overall construction value. Obviously, the lower the overall construction value (CV), the higher the percentage cost of Liability insurance. Regardless of the percent of CV, premiums can be incredibly high. In some cases, this cost is not entirely offset by chargebacks to subcontractors; many subcontractors don't have the Liability coverage on their master General Liability program and therefore can legitimately say they have not included the cost in their bid. In many cases, there is actually an up-charge to subcontractors for participating in the General Liability-only wraps on condos. So, the question arises: who bears the additional costs? Owners and developers are becoming aware of these costs and of where the burden should rest: with the end product; i.e., the condo units themselves and those who buy them.

A cottage industry of condo lawyers has sprung up to work on condo-related documents. This expertise is widely available now and will likely be helpful in the next condo growth cycle. These specialists have been particularly helpful with risk allocation among parties and identification and documentation of condo association and condo unit owners' responsibilities.

Another cottage industry has grown and matured during the past couple of years: quality assurance and quality control (QA/QC) third-party specialists. The participation of these experts is now often required as a condition of getting insurance. Like condo lawyers, QA/QC people have become a familiar part of the insurance equation.

## The Liability Marketplace: Mixed-Use Developments

Mixed-use developers are a subset of the condo boom but they seem to garner more respect from underwriters, translating into better Liability terms and conditions. Where frame-type, smaller condo developments are not thriving now, concrete and steel, mixed-use developments (often combining hotel/condo projects with mixed use retail and office space) continue to flourish in many areas of the country. Underwriters seem to like these projects. We see standard markets participating in these risks in many cases because the general contractor is otherwise insured by the standard market. Defense coverage is often found outside the limit of liability, and pricing and retentions are relatively favorable and more in line with commercial construction. Limits, too, are available, upwards of \$100 million per project.



These projects likely will end up in the standard market unless there is a compelling reason to seek a General Liability-only wrap in the E&S market. The standard market is more likely to be involved due to its client base and the fact that it likely already insures the general contractor and probably several key subcontractors. The insurance on these deals will continue to be driven by the general contractors – usually large, well known and risk-savvy companies. Pricing and conditions should remain appealing to buyers throughout 2007.

## Summary

While the construction industry in the US moves away from residential for the foreseeable future, the insurance industry has actually gotten quite comfortable (as much as the industry ever gets comfortable) with residential risk. Products for homebuilders have now been in place for several years. The General Liability wrap-up product from the non-standard insurance marketplace, developed during the past couple of years, is now a mainstay for certain types



of condo projects. If you are a large contractor with a standard market construction insurer and you are working on a large, concrete and steel mixed-use development, you likely have coverage from the standard market.

As the residential construction insurance marketplace has settled down, pricing has moderated, with premiums decreasing 20 to 30 percent for General Liability-only wrap-ups on condos. We also find more bidders for the insurance and there are a few new non-standard market entrants. Capacity is available and the service industry to support these risks is more evolved; QA/QC third-party firms and lawyers with experience in developing condo documents are plentiful. Underwriters are already looking for the next insurance crisis as the Liability crisis of 2001 has, for all intents and purposes, been tackled.

While the outlook for 2007 is positive, the potential for volatility remains. The market involves non-standard carriers, and negotiations over terms and conditions can be intricate. An experienced risk management partner, as always, is an important asset. For more information, and for more on market conditions for the construction insurance marketplace, contact your Willis Client Advocate or a representative of the Willis Construction Practice.



## At the Bar: *Kvaerner*

In October 2006, the Pennsylvania Supreme Court ruled that faulty work does not constitute an "occurrence" under a Commercial General Liability (CGL) policy. The case of *Kvaerner Metals Division of Kvaerner U.S., Inc. v. Commercial Union Insurance Company* (Pa. Oct. 25, 2006) involved an underlying complaint brought by Bethlehem Steel Corporation which alleged that Kvaerner Metal Divisions agreed to build a battery according to certain plans and specifications that were part of a contract; that Kvaerner warranted that its materials, equipment and work would be free from defects; and that it would repair and replace any defective work or materials. The allegations claimed that Kvaerner breached the contract because the battery was damaged, did not meet contract specifications and warranties, or applicable industry standards. Bethlehem sought replacement of the battery or the difference in the value of the battery it received and the one that the insured warranted it would deliver.

After receiving the underlying complaint, Kvaerner reported the claim to National Union, its CGL carrier. National Union declined coverage. A declaratory judgment action commenced with National Union arguing in a summary judgment motion that the policies only permitted coverage for allegations of "property damage" caused by an "occurrence," which was defined by the policies as an accident, and Bethlehem had not alleged that the battery was damaged by such an occurrence. Kvaerner argued that the policies included "completed-operations coverage" and that such coverage included damages to improperly completed work product performed by a subcontractor (subcontractor exception to the exclusion).

The case involved various litigation opinions at both the Superior and Supreme Court levels in Pennsylvania. In the final opinion, the Pennsylvania Supreme Court answered the question of whether the allegation of improper work met the definition of "occurrence" within National Union's policies. Citing the landmark South Carolina case *L-J, Inc vs. Bituminous Fire and Marine Ins. Co*, the court opined that the definition of "accident" required to establish an "occurrence" under the policies cannot be satisfied by claims based upon faulty workmanship.

In the decision the court did not look further into the policy to evaluate underwriting intent on issues such as the Subcontractor Exception to the Damage to your Work Exclusion.



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## Cornerstones

### On the Beam

David Grigg has seen the construction world from two sides – literally and figuratively. Born and raised in Perth in Western Australia, he earned a Master's Degree in architecture and urban planning in New York. His career journey then took him from design-build work to consulting and finally to insurance. He landed in the brokering business in 2002 and joined Willis in 2006. He's our resident Professional Liability expert, and brings to bear his broad experience as a construction professional and a liability expert.

David's background – quite unusual in the broking business – gives him exceptional access to markets and great perspective on program strategy. He's been the driving force in improving our already leading-edge service in professional Errors & Omissions (E&O) coverage.

David's introduction to the business side of the building world came when he left the architecture firm that hired him fresh out of Columbia University's graduate school. He and a friend from Australia set up a business helping Australian investment firms get involved in construction projects in the US. The 1989 stock market crash put a freeze on such investments, and in this budding enterprise, and David found himself back at the drafting board with a design-build company in Princeton, NJ. He realized he preferred the business end of his field and took a job as the head of marketing and communications for Louis Berger International in East Orange, NJ, one of the largest transportation consulting and engineering companies in the world.

The insurance business came calling in the form of California specialist insurer DPIC, which set up a management consulting subsidiary in New York with David at the helm. Once it was up and running he was asked to focus on insurance, in addition to business and project management activities. The move to the brokerage side followed two years later.

David is also the editor of *I-Beam*, the Willis Professional Liability newsletter for the construction industry. *I-Beam* was launched in June 2006 with an examination of E&O coverage for individual projects, pointing out two types of coverage, Project-Specific Professional Liability and Owner's Protective Professional Indemnity (OPPI). Issue two treated the legal liabilities of construction managers, contrasting the issues facing construction managers-at-risk and agency managers. The most recent issue focused on private-public partnership (PPP), offering a capsule history and a review of risk issues that come with PPP projects. (To download copies, [click here](#).)

David is married to an architect, Ellen Grigg, whom he met on a trip to the Frank Lloyd Wright masterpiece Falling Water near Pittsburgh. They have two children who have yet to show an interest in their parents' line of business.

Look for the next issue of *I-Beam* in the coming weeks – the topic will be the E&O issues that accompany mergers and acquisitions in the construction world.

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**Born:** Perth, Western Australia, "the sailing capital of the world"

**Educated:** University of Western Australia and Columbia University

**Favorite thing about the insurance industry:** "I love working with architects and engineers and I enjoy working with my colleagues at Willis. The team culture is something I haven't had before."

**Least favorite thing about the insurance industry:** "You can't get a quote on PLI until two days before it's going to bind. Those Property guys who get their quotes 60 days in advance, they have no idea."

**Interests:** architecture, cooking, sailing, reading

## P&C Market Update Excerpts

*The following contains excerpts from the recently published market analysis by Paul Becker, President of the Willis North America Construction Practice. For a complete version, please [click here](#). A companion piece on the insurance marketplace for habitational construction appears in this issue.*

### Construction Insurance Property & Casualty Market Update

The US Property and Casualty insurance marketplace is emerging from a year of record-setting profitability. The industry's underwriting performance, as measured by the combined ratio, is projected at 93.2 and, if accurate, 2006 will represent the industry's best underwriting performance since 1936. Total capacity of \$481 billion is expected, due in large part to low catastrophic claims, with approximately \$60 billion in profit for the P&C industry. This bodes well for buyers of insurance in 2007, as we saw a slowing of premium growth during the past 12 months. Premium growth, usually driven by rate increases, is expected to end 2006 at 3.3 percent and slow further in 2007 to 1.8 percent. Compared with 14.6 percent in 2002, the height of the last hard market, the drop is significant.



The industry numbers mentioned above for the US Property and Casualty market represent all segments, not just construction. Construction underwriters – those who dedicate resources, marketing and capital to the construction industry – confirm that their books are performing well, with at- or below-industry averages for their combined ratios.

While premium growth is slowing and rates are flat-to-lowering in most lines, buyers should be mindful of certain trends, especially in the construction insurance marketplace. To that end, you will find below a discussion of rates and trends by line of coverage along with expectations for 2007.

The market update reviews the following lines of coverage:

**General Liability** – Conflicts continue between buyers' coverage needs and underwriters' interpretations.

**Workers' Compensation** – Collateral requirements are a major issue; with the maturity and longevity of loss-sensitive rating plans, many contractors have collateral being held by two or three insurers.

**Excess Liability** – The key is the lead underwriter for the first excess layer and specifically the underwriter's underlying limits requirements.

**Professional Liability** – While there are always exceptions, for the most part, this line is expanding.

**Environmental Liability** – The critical question is how to manage increasingly restrictive terms and conditions.

**Builders Risk and Property Coverage** – Capacity, deductibles and pricing will continue to present challenges for risks in the southeastern US.

### Summary

The 2007 Property and Casualty market for contractors will be much the same as in 2006: stable in terms of rates, with modest decreases in most lines and tighter terms and conditions in the General Liability and Excess Liability lines of coverage. Expect continued erosion of coverage granted in the General Liability and Excess lines of coverage, either literally by endorsement or effectively by claim handling and litigation in certain states and regions of the country grappling with the business risk issues involving faulty workmanship and the definition of occurrence. Property lines, for the most part, are stable with rates down (the exception being coastal wind Builders Risk coverage and California Quake coverage). Workers' Compensation is enjoying a great run, primarily due to legislative changes, while Professional and Environmental coverages require tailoring to fit specific defined exposures to assist underwriters in pricing of their risk.



Other issues to watch for include potential catastrophic losses, carriers and financial health, and overall trends in construction liability coverage restrictions. One of the biggest potential risks for 2007 is catastrophes. With the massive coastal housing and commercial build-up during the past several years, most analysts expect \$40 billion catastrophic losses to become more prevalent. Most in the industry also say that it is reasonable to expect a \$100 billion catastrophic loss year soon.

Along with this concern is the overall financial well-being of the P&C industry in the US. While 2006 was record-setting and the industry is flush with cash, the next step is generally the setting aside of underwriting discipline and the fight for market share. Without many new standard insurance market entrants into the construction segment, the few that exist need to decide and define how they will participate. While several have their paths outlined, others search for their niche; this can also be said of the construction-focused excess and surplus lines carriers that wrote significant premiums in habitational wrap-up coverage during the last couple of years. However, even with increased competition based on strong capital, coverage restrictions and interpretations may allow underwriters to stave off the dreadful loss trends they were saddled with after the last soft market in the late 1990s. It is incumbent on buyers and their representatives to maintain the standard of coverage and traditional legal interpretation for contractors. This may be the biggest challenge we face as a risk management community in 2007.

## 13th Annual Willis Construction Risk Management Conference

There's still time to register for the leading US construction risk management event of the year, being held at the Franklin Marriott Cool Springs in Nashville, TN, May 9-11. Registration forms must be received by April 10.

The conference will present our usual mix of broad perspective and close inspection of hot topics. In the former category there is the state of the insurance market address from Willis Construction Practice President Paul Becker. Willis experts and guest speakers from many organizations across the country will be delving into the latter. The topics for this year's conference cover a wide range, including "Why Are the Costs of CGL Property Damage Claims Rising?," "Bonding Capacity," "When Do You Need an OSHA Lawyer?," "Using Quality Assurance to Reduce Risk," "Lessons Learned: Project Drawings – If You Pay for It, Do You Own It?" and "Environmental Policies and the Mold Mirage."

For more information about the conference or to receive a registration form, please contact Cheryl Irby at 615 872 3461, [cheryl.irby@willis.com](mailto:cheryl.irby@willis.com) or Paul Primavera at +1 410 527 7240, [paul.primavera@willis.com](mailto:paul.primavera@willis.com).

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