

MAKING SENSE OF THE LIABILITY INSURANCE CRISIS

For Brothers Strong, a remodeling firm in Houston, the difficulty began in January 2003, when its insurance carrier announced it was

by Clayton DeKorne

pulling out of the Texas market and canceled the company's general liability policy. Several other carriers also pulled out of Texas around the same time, leaving just a few willing to write new policies for remodeling contractors, and only at significantly higher premiums. "We felt our backs were against the wall," explains Michael Strong. "Since we had never had a claim against us and liability coverage is not required here, we thought we'd try going without it. That wasn't so easy." The company immediately lost one lucrative client who balked at the company's decision to remove its notice of insurance from the contract. Then Brothers Strong almost lost control of its office property when a balloon payment came due and the bank demanded proof of business insurance to resume financing. The company finally found a carrier willing to write a new policy in April. But the firm had to raise its deductible to \$5,000 and absorb a 35% premium increase. That was on top of a 20% hike in its premium the year before.

Across the country, builders and remodelers have been reporting similar

nightmares. Carolyn Nelson of New Spaces, a design-build remodeling firm in Minneapolis, reports that her company got off easy with a 30% increase in rates after its insurance carrier pulled out of Minnesota. Remodeler Jim McGrath of Acton, Mass., was forced to take a new liability policy at double his previous rates after his insurer stopped underwriting all residential contractors. Custom builder Lewis Green of Winthrop, Wash., lost his insurance after his carrier abandoned policies for all residential GCs. Among the companies left in Washington State that were willing to write a policy for Green's company, only two were preferred carriers. He chose one and was handed a 300% higher premium and a pile of paperwork. "The price increase is one thing, but it's the paperwork involved that's killing me," says Green.

How Did We Get Here?

There's no single cause for what has been dubbed the "hardest market in insurance history" by industry analysts. The market for commercial general liability (CGL) insurance started to go awry at the end of 2000 when stock markets headed south, depressing the substantial investments assumed by carriers during the 1990s. Despite gains made in the investment boom, the industry was poorly positioned to sustain any losses.

As insurance carriers cancel coverage and raise rates, builders and remodelers across the country must adopt new risk management strategies

"The '90s brought a lot of new construction business, creating a highly competitive insurance market," explains Cam Dickinson, vice president of broker services for Woodruff-Sawyer & Co. in San Francisco. "To capture new business, insurers often underpriced premiums relative to the risks they were covering."

According to the Insurance Information Institute, over the decade of the 1990s, residential property claims cost insurers about \$1.18 for every \$1 in premiums they collected. Reasons for the shortfall are varied. Natural disasters — including Hurricane Andrew and the Northridge earthquake, as well as wildfires, tornados, tropical storms, and hail — accounted for the largest percentage, resulting in over \$100 billion paid out by insurers. Disaster-related losses cost about \$700 million per

month over the last 12 years, according to estimates by the Insurance Information Institute. In addition, failures in exterior insulation finish systems (EIFS) have been a major source of claims in California and other western states where stucco exteriors are common. Other large claims have come from homeowner associations (HOAs) representing condominium and multifamily housing communities filing class-action suits, largely for hardboard and other nonwood siding failures. All totaled, these losses put the industry in deficit when three major insurance catastrophes struck.

Mold. The first came in June 2001, when a Texas court awarded homeowner Melinda Ballard \$32 million for a toxic mold claim (see *In the News*, 1/03). This case drew widespread media attention and sparked an explosion in mold-related claims across the country. Since 2001, insurers have paid out over \$1 billion for mold-related claims in Texas, where 70% of the claims have surfaced. California and Florida, followed by Arizona and Oklahoma, are also coping with a surge in water-damage claims, which are increasingly associated with mold and increasingly expensive. According to insurance industry figures, the average mold claim costs 5.6 times more than the average non-mold-related water damage claim.

Circumstances grew alarmingly worse for insurers three months after the Ballard case made news, when the events of September 11 heaped on nearly \$70 billion in claims against commercial insurance companies and reinsurance companies (the insurers of insurance companies), leading to bottom-line losses for the insurance industry as a whole for the first time in history. And if all that weren't enough, the collapse of Enron and other companies with ties to the surety bond market forced carriers to dip into reserves they hold for anticipated claims, triggering a drop in carrier ratings.

Not surprisingly, carriers are now scrambling to shed high-risk business in an attempt to stem losses, and to raise premiums to generate revenue. "The end

Subcontractor Indemnification

Old

Insurance requirement: The Subcontractor hereby warrants to the Contractor that the Subcontractor is fully insured for both liability and workers' compensation. The Subcontractor is hereby required to provide proof of current insurance to the Contractor and hereby promises to maintain such insurance in good standing.

New

Additional insured endorsement: The Bodily Injury and Property Damage Liability policies shall include a provision or endorsement naming both the Owner and the Contractor and their officers and employees as additional insureds with respect to liabilities arising out of the Subcontractor's performance of the work under this Contract, and providing that such insurance is primary insurance with respect to the interest of the Contractor and that any other insurance maintained by the Contractor and the Owner is excess and not contributing insurance with the insurance requirement hereunder. The additional insured endorsement shall provide coverage at least as broad as Additional Insured (Form B) endorsement form CG 20 10 11 85 as published by the Insurance Services Office (ISO).

result is that insurers are looking for ways to get out of anything they feel can't provide good earnings," explains Dickinson. In most states, that "anything" has been commercial liability in the residential construction market, which historically earns the lowest margins for carriers.

Enforcing Business Standards

Regardless of *why* the liability insurance crisis has occurred, builders and remodelers need to understand exactly *what* the crisis means. "At this point it's not an availability problem. It's a cost problem," insists broker Susan Brodahl of the Heffman Group in Portland, Ore. Even though some are pulling out of the commercial liability market, carriers are still writing all lines of insurance in every state, claims Brodahl, who works with builders nationwide. But there's a catch: Not all builders may be able to qualify for a liability policy. "With higher premiums come much stricter underwriting terms," says Brodahl. "Carriers are being very choosy about who they decide is insurable, and who's too hot to handle."

To qualify, builders must be willing to adhere to certain standards of doing business. Carriers will be looking for businesses that have put clear "risk management" policies in practice. Risk management typically includes contract language that purposely transfers risks to owners, architects, and subcontractors, where appropriate. Risk management also includes a range of practices, such as safety training and job documentation that will either reduce the chance of claims or streamline how they are settled. Here are some of the key provisions insurance carriers want to see:

Indemnification. CGL policies rarely ever covered noninsured subcontractors, so standard practice has always been to request a certificate of liability insurance from subs. But now carriers have raised the bar and are asking for clear indemnification language in subcontractor agreements, typically in the form of an additional insured endorsement (see "Subcontractor Indemnification," previous page).

JLC legal columnist Quenda Behler

Story calls an indemnification requirement "a device for passing off risk onto someone else in a game of financial tag." In this day of strict underwriting, insurance companies are doing everything possible to ensure that every party involved is covering its piece of the pie. Most of all, the carrier wants to be sure that its policyholder is not left covering a liability for work he or she did not directly perform.

"The key terms in the clause [of the "new" language shown on the previous page] are 'primary' and 'not contributing,' explains Brodahl. "These establish a hierarchy of policies, indicating which one will pay first in the event of a claim." Without clear indemnification, a claim is more likely to result in a messy dispute between competing insurance companies, which will drive up legal fees. "This is exactly what an insurance company is trying to avoid," says Brodahl.

Indemnification is not an easy sell, however. "Subcontractors are definitely balking at this," says George Schluter, a custom builder in Kansas City, Mo. "Their insurance companies are coming back to them and saying it's not necessary. It's a struggle between the insurance companies over who's going to cover what. So far I've been able to maintain all my old subcontractor relationships, but it hasn't been easy."

To avoid a struggle, custom builder Lew Green has taken a deliberate course of action with each of his long-time subcontractors: He first sends out a letter and the necessary paperwork to each subcontractor, explaining that the enclosed several forms must be completed before he will forward plans or request a bid for any job with his company. Inevitably, he gets a call from the sub, and if it's someone he's worked with successfully in the past and wants to retain, he invites the sub out for breakfast, on him, to discuss his concerns. "A few balked early because of increased costs to them. Several had to increase their coverage. So far, I have not lost a sub that has performed well for me in the past, but a couple are waiting until a little later in the season to complete and send all of their paperwork to me." Green

"My insurance company has left California. The new company jumped my premium from \$1,400 to \$7,300 — a 520% increase — and I was lucky to get it."

"My liability policy was not renewed because I didn't meet their new guidelines — no more than 40% of sales by subcontractors."

"My premium last year was about \$13,000; my new policy will cost me \$44,000 — quite a pill for my clients to absorb, but I see no other choice."

Selecting a Broker

Broker selection requires a shift in thinking about what insurance is. Rather than treating insurance as a commodity, treat it as a service. This means hiring a broker the same way you might hire a lawyer or an accountant. You wouldn't shop for legal counsel or accounting services based just on price and without considering the quality of the consultation. In the same way, insurance brokers are best judged on the basis of their performance.

Here are some key issues to consider in finding a broker that fits your company:

- **Ask for references from a trusted source.** Local and regional trade associations often recommend or even sponsor a limited selection of brokers. Ask other remodelers which brokers are good.

- **Find out how many similar contractors this broker serves.** Look for specific similarities with your business. Whether you do one or two high-end houses a year or specialize in ocean-front properties or whatever, ask the broker to show you a company in a similar category that the firm has represented.

- **Ask to see the brokerage firm's marketing plan.** How does this broker sell itself? The marketing plan will at least tell you whether the brokerage is actively trying to solicit your type of business, has hired staff to address that sector, and has conducted industry-specific research.

- **Beware cold calls.** Don't just go with someone off the street who happens to call. But if a broker does solicit your business, consider investigating who the firm has worked with and what sources might be willing to vouch for it.

- **Trust your instincts.** Ask the broker point blank, What will this policy cover? If you've been buying insurance, you have a sense of whether a broker is above board. If a broker is shiftily, it will be easier to spot than you think.

- **Don't shop for a new insurance policy every year.** If you do, you may get pegged as a price shopper. It's much safer to expect a broker to shop for a new policy every three to five years.

- **Time it right.** Begin your search at least 90 to 120 days before your premium comes up for renewal. At 60 days before, make a decision to go with a broker and then sit tight. This will give the broker time to get her ducks in a row, but keep in mind that often the broker will be locked out of buying a policy until the day before it comes due.

- **Do not shop for carriers.** In the current climate, let the brokers shop for coverage; don't do it yourself. "Carriers are looking for reasons not to write residential contractors, and shopping for price gives them more reason to say you're not a good risk," Susan Brodahl says. "Carriers don't want to waste time on a contractor who isn't interested in forming a long-term relationship," confirms Cam Dickinson.

A good broker should be someone you would hire to be part of your team and, in most cases, someone who will be intimately involved in every aspect of your business. So hold that person to a high standard of business. Little things will be good indicators. For example, how soon does the broker return your calls? If you feel that communication is lapsing, it may be a sign to move on.

acknowledges that this is nothing new. Insurance companies have always wanted these terms but now are withholding coverage unless he sticks to the rule of not letting a subcontractor enter the job site without completing the forms, then passing a copy of the forms to his insurance agent to keep on file. "Last week, a well driller said, 'What, are you going big business?' I laughed. I guess I am."

Further troubles may arise in the future, however, as tightened insurance requirements extend to subcontractor and artisan contractor policies and it becomes more difficult to get additional insured status on completed operations. If preferred subcontractors cannot provide it because their insurance companies refuse, it may be necessary to rely on the more limited protection provided by alternate endorsements, but that's where carriers may decide to drop coverage.

What's the way out of this catch-22? A great deal will depend on the quality of the relationship you form with an experienced broker who can negotiate the differences between you and the carrier (see "Selecting a Broker," previous page). The carrier will want proof that you have exhausted all other means of finding a reputable sub and will inevitably want to review records for past jobs involving the subcontractor in question. "This will require an enormous amount of paperwork, so brace yourself," Brodahl advises.

Exclusions are an important part of any liability policy. They provide a back door for carriers to expressly avoid certain kinds of high-risk work. Most exclusions are aimed at avoiding ultra-expensive bodily injury claims. These days, almost every CGL policy also includes clear exclusions for mold (broadly written as "toxic organic material," just in case new killer life forms should begin growing in houses), asbestos, lead paint, and radon. Insurers will want to see contract language that supports these exclusions, stating what a company will do if any of these toxic substances are found on the job site (for example, cease work and make provisions for a specialty abatement contractor to remove the risk at the owner's expense).

More and more, CGL policies for general contractors are also excluding coverage for any roofing, siding, or window-replacement work. These exclusions are an offshoot of the mold exclusion, aimed at reducing water damage claims that may lead to mold problems. Liability for this type of work, insurers presume, is to be handled by subcontractors.

Audits and inspections. Increasingly, insurers will ask to examine your financial and business records. This audit has always been a requirement, but it has not always been enforced. Insurers typically audit records, looking for verification that their premium basis matches the coverage and accurately reflects a business's actual exposure. Generally, audits are done when the premium determined at the beginning of the coverage period is based on estimated units of exposure (payroll and/or sales records, for example). "None of the paperwork is new," claims remodeling contractor Dick Seibert of Martinez, Calif. "What is new is that underwriters are requiring all the agreements for review."

Increasingly, insurers are exercising their right to inspect operations and business facilities, and to prepare reports on their findings and make recommendations to the insured. Again, insurers have always had this right (it's printed in tiny letters) but have not always exercised it. For example, inspectors may be taking a keen interest in the way you're flashing roofs and windows or backfilling excavations, in an effort to reduce the chance of water damage.

Insurance inspectors can't shut down a job, but they can help alert you to risky practices and identify ways to reduce the chance of a claim. The inspection might also identify specific liability exposures that fall outside the scope of general liability insurance and should be separately insured, possibly leading to still higher costs.

Complete coverage. On top of a commercial liability policy, contractors need property insurance for shops and offices, auto coverage for company trucks, separate policies for job trailers and tool inventory, plus workers' comp. In some

"My options are to carry no liability insurance, lie on my application, or quit the business."

"The only thing that keeps my premiums in line is the fact that I physically work on the job on a daily basis. If it weren't for that, my agent told me my premiums would be through the roof."

"My builders' insurance was cancelled at the end of last year. I had never filed a claim against it, and paid every bill perfectly on time."

areas, a separate builders' risk policy may be required for each project, in addition to the umbrella CGL policy.

According to Mike Weiss, CGR, GMB, CAPS, owner of Weiss & Co. of Carmel, Ind., and current chairman of the NAHB Remodelors Council, risk management begins with a *risk profile* — a thorough analysis made each year that categorizes your risk. The purpose of this analysis is to identify which risks can be “managed” — that is, transferred to someone else or reduced by operational procedures, such as better crew communications and safety training — and to identify gaps in your insurance coverage.

Gaps in coverage are not always obvious. For example, a general liability pol-

icy probably won't apply to a home office, and your own homeowner's policy may exclude coverage for any building materials stored in your garage or damage that is caused by those materials. A rider may not even be available to cover them because they are business liabilities. Another common gap arises when employees use their own vehicles on the job. A rider is available for that.

“A risk analysis should be the first thing a broker offers, but it's not enough to throw it all on the broker,” says Weiss. “Someone in your operation must become an insurance expert, which simply means you sit down and actually read all those tiny words on the policy” (see “The Nuts and Bolts of CGL” below).

The Nuts and Bolts of CGL

Deciphering a commercial general liability policy makes for the driest reading you can imagine,” says Mike Weiss. “But someone in the company — preferably the person with the most experience and knowledge of operations — must take the time to plow through the policy word for word.”

In general terms, this is what you'll be looking at: A CGL policy is designed to pay for claims made against you by third parties (not your employees) for damage or injuries caused by you or your employees. The policy pays any sums a company may be legally obligated to pay in damages, not to exceed the policy limits.

Policy limits. CGL policies are typically priced according to their limits. Most CGL coverage contains six different limits. Each limit represents the maximum amount the insurer will pay for a particular type of covered loss; they may appear as follows:

General aggregate \$2,000,000
Products or completed operations aggregate \$2,000,000
Each occurrence \$1,000,000
Personal and advertising injury \$1,000,000
Fire damage legal liability \$300,000
Medical expense \$5,000

General aggregate limit is the most the insurer will pay for the sum of all claims made during the policy period, not including those involving products or completed

operations hazards.

Products or completed operations aggregate limit is the most the insurer will pay for the sum of all bodily injury and property damage claims that arise from the work you produce. In the event of a catastrophic loss — an addition you're working on collapses in a wind storm, for example — the value of the property damage will be determined by how much of the work you've completed, not the estimated value of the entire job. If one of your employees has purchased materials that you have not yet paid for, the losses may not be covered. If a sub has stored materials that are destroyed and you do not have clear contract provisions indemnifying yourself for the loss, the subcontractor may complicate the claim by seeking reimbursement. These scenarios underscore the importance of careful documentation and clear indemnification, and explain why insurers are increasingly interested only in contractors who follow careful business procedures.

Each occurrence limit is the most the insurer will pay for the total of all bodily injury, property damage, and medical expenses incurred for any one accident. An occurrence is commonly defined as “an accident, including continuous or repeated exposure to substantially the same general harmful condition.” Bodily injury is defined in the policy as “bodily injury, sickness, or disease sustained by a person, including death resulting from any of these at any time.” Property damage is

Coping With Costs

While risk management will limit your risk and, in the best cases, allow you to streamline and coordinate all aspects of the company, it's not likely to save you any money. Indeed, the added training and time spent hovering over mind-numbing contracts and itemizing company operations will likely increase your overhead. Moreover, there aren't many ways to cut the immediate increase in premiums. But there are a couple of effective ways to help manage these costs.

Raise deductibles. The only viable way to lower a premium is to raise the deductible, but this must be done with careful forethought. A higher deductible will expose your company to more risk,

so the first step is to evaluate just how much exposure the company can absorb. Weiss advises raising the deductible only if you are disciplined enough to set aside that deductible amount, ideally in the highest-yield money market fund or other safe financial vehicle available. In a good market, this approach can work to your advantage, earning some interest income. In a practical sense, this is a step towards *self-insurance* — a maneuver that makes sense if you have the required capital set aside. At the very least, it may help improve your financial profile and won't leave the company short in the event a claim is made and the deductible must be paid.

Don't play with policy limits. While a

defined as "physical injury to tangible property, including all resulting loss of use to that property," as well as "loss of use of tangible property that is not physically injured." In an investigation of a claim, the carrier will be scrutinizing the claimed *loss of use* to see if it fits in a precise definition: The loss must have occurred at the time of the accident.

The property damage claim will also be measured in monetary terms: It typically includes the value of the property, if it is destroyed or must be replaced, and the cost to repair the damage if such repair can be made. If the property is income producing, or if a temporary replacement of the property is needed until the property is restored to use, then damages for loss of use can also be advanced. Often the biggest disputes arise out of a difference in the value of the property declared by each party.

Personal and advertising injury limit is the most the insurer will pay for the total of all personal injury and all advertising injury sustained by any one person or organization. Losses paid under the personal and advertising injury limit are also deducted from the policy's general aggregate limit. The personal injury coverage protects against suits brought by third parties alleging that your business committed any of the following offenses: libel, slander, defamation of character, false arrest, disparagement of goods, and similar allegations, provided the offense was not done intentionally by or at the request

of your business. The advertising injury coverage insures against disparagement of goods, slander, right infringement, and similar allegations that may arise in connection with your advertising. Increasingly, insurers will want to scrutinize all ads, brochures, flyers, and even the Yellow Pages, examining them not only for possible injury, but also examining the types of claims you make and the type of work you sell.

Fire damage legal liability limit applies to damage arising out of any one fire, and many policies provide a \$300,000 limit. This limit is a subset of the each occurrence limit, which applies to all property damage in any one occurrence. Higher limits are generally available.

Medical expense limit is applicable to all first aid and covered medical expenses for bodily injury to any one person resulting from any one accident. Medical expense coverage is a type of "no fault" insurance. This coverage will pay reasonable medical bills of third parties who are injured on your premises or by your operations, subject to the per person limit listed on the policy. The limit for medical expense is typically \$5,000, but it can be increased up to a maximum of \$25,000. Medical payments coverage pays for injuries sustained by a third party at your premises or by a third party's operations regardless of legal liability. Taking this approach to medical expenses is thought to reduce the likelihood that injured parties will bring a lawsuit against you.

"My insurer said they are no longer offering coverage for general contractors in the state of Florida. I believe this is due to mold hysteria."

"Last year my liability insurance was \$845. This year I am told that it will be \$24,000. The reason given was that I have done some roofing and two EIFS homes within the last 10 years."

***Quotations from JLC Update online survey, posted at jlconline.com**

lower-limit policy may be cheaper, it's rarely a practical choice. "It's not like you're going to have a smaller accident," points out Brodahl. Cover what the risk is worth. If you're working in million-dollar houses, make sure you're covered for at least a million dollars for each occurrence. If you're covered for only half a million dollars, you're wasting your money on that policy because it's not going to save your company from bankruptcy in the event of a million-dollar claim.


Incidentally, setting higher limits is not always the best way to cover yourself, either. More often than not, lack of coverage will result in gaps in your coverage — for your lead carpenter's truck, for example, or builders' risk coverage that expires sooner than you think it will — that results in messy and costly claims.

Raise prices to cover costs. "In this market, the best a builder can do is charge appropriately to cover the increases," advises Brodahl. Typically, general liability insurance premiums are treated as an indirect cost — they're based on gross receipts and not tied to a single job — so the expense should be assigned to fixed overhead and prices raised accordingly to cover the increase. However, Brodahl recommends adding it as a line item on each job, rather than as a fixed cost. For example, on a \$100,000 job, your insurance cost may be 4%, so include in your job costs a line item of \$4,000 for insurance. "Upping the overhead percentage does not include insurance as a variable cost, which it is," argues Brodahl. "Contractors can only consider property and auto coverage as fixed costs that can be included in overhead. Liability and workers' compensation are variable costs that need to be built into each bid." In addition, Brodahl cautions, if you're bidding past your renewal date, you need to know the type of increase that's headed your way. A broker will be able to advise you on that increase.

Regardless of how you charge for added insurance expenses, raising prices may prove to be a tough decision in a slow economy when customers are

growing increasingly tight fisted. "This insurance market compounds the problem by encouraging more contractors to go it alone, without coverage, allowing them to underbid the ones that do carry insurance," posits Chris Hawkins, an independent insurance agent in Houston.

"Ultimately, this will be an issue that decides who will stay in business in the future," says Weiss. "Going without insurance won't work for those who plan to stay in business for the long run, nor will undercutting prices or sacrificing profit or any other way we might try to get out of this. In the end, those who stick to a sound business strategy, which necessarily means accounting for the added costs and charging for them, will come out ahead."

It may be a long while before builders and remodelers see premium prices fall again, but most insurance experts agree that they will fall. "The history of the insurance market has always been marked by shifts up and down," Brodahl concludes. "The correction we're seeing now is so severe simply because it was down for so long. But it will relax. It always does." 

*Former JLC senior editor **Clayton DeKorne** continues to report on breaking business and technology issues from Burlington, Vt., and Brooklyn, N.Y.*