

A Thought Leadership White Paper by Beecher Carlson

Construction Risk Today:

Exploring Alternatives to Traditional Insurance

A look at the legal issues associated with construction defect insurance and how to use captive insurance companies to manage construction risk.



BEECHER  CARLSON

Solving insurance and risk finance issues related to construction defect, warranty and subcontractor coverage isn't as simple as it used to be. Increased litigation has caused enormous changes in how insurance is written, how claims are resolved and how contractors and builders are choosing to manage their risk. More than ever, construction-related businesses are turning to alternative risk finance methods – including captive insurance companies – to gain more control and keep costs in check.

The Legal Landscape:

Trends in Construction Defect Coverage

Over the past several decades, construction defect litigation has increased substantially across the country. Like many trends, this one started in California, which was the first state to recognize strict liability in residential property construction defect disputes, essentially treating homebuilding as a mass production environment, with houses as the product. This litigation momentum continues to move east, and construction defect suits against developers by homeowners and condominium associations are becoming more common.

As expected, insurance companies are attempting to avoid paying claims on construction defect coverage under commercial general liability (CGL) policies. Using the business risk doctrine as the basis for their argument, they assert that there is no coverage for defective construction under CGL — that defective construction is not an “occurrence” under the policy, that it is not an accident, nor is it neither something unexpected nor an unintended consequence. Several court cases have addressed this issue, and more are now underway.

What do the experts advise? To avoid problems, clients should meet with the underwriting unit and claims department simultaneously before policies are written, ensuring that all parties are on the same page regarding coverage intent. Also, clients should keep their own records of these meetings and document all discussions. When it comes to claims management, good documentation can be very helpful.

Legislative and Regulatory Issues

There are several issues of interest to contractors and developers in the current legislative and regulatory arena. It is crucial for builders to know how these laws work in each state in which they operate.

Statutes of Limitation — Statutes of limitation are laws that set the maximum period of time in which a lawsuit or claim can be filed. The period of time varies from state to state for different types of lawsuits. Contractors should be aware of the statutes of limitation relative to their work in case of potential negligence or breach of contract issues.

Statutes of Repose — Statutes of repose are laws that set the maximum period of time for which a manufacturer, contractor or developer can be held liable for the performance of a

How to Minimize Litigation

Developers and contractors can take several steps to avoid lawsuits:

Develop a good contract. Include appropriate dispute resolution clauses, including arbitration and mediation.

Document everything. Be prepared for litigation by documenting turnover conditions. Clearly and realistically spell out maintenance responsibilities for the homeowner.

Be proactive. Be diligent about customer satisfaction and encourage homeowners to work directly with the builder to resolve issues. Monitor weblogs to gain insight about the types of issues that may arise.

Retain records. Do not rely on the insurance broker or carrier to keep copies of policies or other documents. Be sure there's a record retention policy in place that reflects appropriate statutes of limitation and repose.

Use wraps. Wrap-up insurance policies can be quite beneficial in minimizing cross-litigation, addressing the statute of repose, and ensuring that all parties, including subcontractors, have uniform language coverage.

product. Statutes of repose recognize that products will eventually stop performing as well as they did when they were new, and that owners bear responsibility for maintenance. Statutes of repose also vary from state to state. Again, builders should be aware of the statutes of repose in their states.

Right to Repair Laws — Western states are leading the way in pushing legislation that gives builders the opportunity to make repairs before a homeowner or homeowner association files a lawsuit. Developers should be aware of these types of laws in their states — some are “friendlier” than others.

Risk Management Challenges

In recent years, residential builders have changed the way they manage risk — instead of transferring risk, many now assume a substantially larger portion than in the past.

The reason for this migration? Insurance carriers generally don't know how to price construction insurance; underwriting and actuarial models don't accommodate the length of time between the completion of a house and the lawsuits that might arise from its building. Also, residential loss experience isn't segregated from commercial loss experience, which doesn't often work to a homebuilder's advantage. Therefore, premiums are extremely high and coverage provisions are often inflexible.

Another challenge is that builders often don't have control over the claims and legal process. Even if builders believe they purchased financial certainty, at claims time, it may turn out that the actual coverage isn't what they thought they purchased. In addition, subcontractors sometimes have exclusions put on their policies, so the certificate of insurance doesn't accurately represent the coverage they actually have.

Consider A Captive

An Alternative Solution

Given the legal, regulatory and risk management challenges facing them today, many builders and contractors are now turning to alternative risk management options — including captives — as they seek better coverage at better prices.

A captive insurance company is a separate legal entity that insures the risk of its owners and sometimes that of related or affiliated firms. Captives began in the 1970s, and are proven entities: there are now more than 5,400 in operation.

Captives are not appropriate for all construction-related businesses, but they work well for those with sufficient insurance premiums and/or retentions to achieve savings. To qualify, companies must assess both their loss experience in conjunction with premium cost, and premium cost relative to the amount of insurance purchased. Those with superior loss experience and disproportionate premium-to-limit ratios may be good candidates for a captive.

If considering a captive, companies should also review their own claims experience and loss ratios relative to their peer group. Low loss ratios are obviously attractive in terms of underwriting. Companies also should consider initial capitalization requirements to fund the captive — usually one third of the annual captive premium (a 3:1 premium-to-capital ratio).

Captives are flexible entities, and can include a number of different coverages:

- **General Liability** — including premises operations and completed operations; this is the most prevalent use for captives.
- **Warranty insurance**
- **Builder's risk coverage** — especially helpful

Types of Captives and Who Uses Them

Pure Captive Aka Single Parent Captive

Large Public Corporations
Regional Private Companies with critical mass of premium

Rent-A-Captive

Protected Cell Captives
Large corporations
Regional Private Firms
Agents with book of profitable business
MGA taking quota share risk on a program

Group Captives

Associations – Small or large premium
Trade or Industry Groups
Homogeneous group by Industry
Heterogeneous group by Coverage
Mid market company looking for more control and cost savings

Risk Retention Groups

Associations
Homogeneous Groups
Industry Groups
Agents & Brokers sponsored groups
Corporations with affiliated groups

in wind- or flood- prone areas; builders may assume some portion of their own catastrophic risk or deductible and fund it through the captive.

- **Difference in conditions** — gap coverage for policies that contain poor coverage conditions, exclusions and limitations.

- **Subcontractor general liability and wrap-ups**

- **Specialty coverage** — including mold, moisture remediation and other risks generally not underwritten by typical insurance coverage.

- **Excess or buffer layer.**

Captives also come in many different structures, designed to suit various types of businesses and their insurance needs:

Pure Captive — Also known as a single-parent captive, this structure is typically formed by a single owner insuring its own risk — usually large corporations or regional private companies with a critical mass of premium.

Group Captives — Group captives are typically formed by a trade or industry association looking to spread risk. These captives can be homogeneous (made up of members in the same industry), or

heterogeneous (comprising unrelated industry members drawn together by similar coverage needs). Group captive participants are generally mid-market companies without critical premium size for their own captive but looking for more control and cost-savings.

Rent-A-Captives — Sometimes also referred to as “Segregated” or “Protected” Cell captives. These structures can be used by large or regional companies who may not want or have the financial ability to capitalize their own pure captive. These arrangements effectively create a leasing structure that offers some, but not all of the benefits of a pure captive. Insurance agents, brokers and wholesalers often use this type of captive to take risk on a book of business. Rent-a-captives are typically run by insurance companies, reinsurance companies, and brokers to broaden their product offerings.

Risk Retention Groups — This structure follows the Risk Retention Act of 1986 and is formed by homogenous groups such as associations or industry groups, agents and broker-sponsored groups, or corporations with affiliated groups. Often referred to as RRG’s, these groups may only be formed for liability exposures. The Risk Retention Act is the only case where federal regulation supersedes state regulation of insurance companies.

Captive Benefits

Captives provide substantial benefits to those who utilize them, including:

Significant Savings: Premiums paid into a captive are based on the loss experience only of the captive itself, so premium savings can be significant. (Of course, premiums are calculated by an actuary — every captive has to have a certified loss forecast and projection and reserve study.)

Lower Overhead Costs: Typically an insurance carrier puts a 30% to 40% load on the premium for profit and overhead, much of which can be saved by a captive. And, if properly structured, premiums may even be tax deductible.

Earning Opportunities: Captives can also earn money — premiums can be invested and generate income that can be used to offset premium charges in the future or pay dividends to the owners.

Tax Savings

Depending on its size, a captive may qualify for tax savings under IRS Code 831B, which applies to small insurance companies. As long as premiums remain below \$1.2 million, the captive's income is tax-free, and the entity only pays 15% tax on the investment income it generates.

Operational Advantages

Captives create more incentive for loss control, greater control over their own claims handling, and more leverage in the traditional marketplace.

Access to Reinsurers

The reinsurance market tends to be more financially driven and more protected from the subjectivities of underwriting. The reinsurance audience is typically quite sophisticated, and can offer far more attractive pricing than the traditional insurance marketplace.

Customized Policy Forms

Customized policy forms offer increased negotiating power which results in more flexibility with premiums and endorsements.

Getting Started

Is a captive right for your business? You'll need specific expertise to determine if a captive is appropriate for your company's risk management needs. Obviously, it is important to work with an organization you trust to guide you through the decision-making process. Give yourself plenty of lead-time — usually three to four months — to work through these steps:

- Conduct a feasibility study.
- Gather data.
- Develop pro forma financials.
- Meet with regulators
- Make domicile decisions — “on-shore” or “off-shore”?
- Complete an actuarial study and secure a tax opinion letter.
- Engage in reinsurance or excess insurance marketing.
- Apply for licensure.
- Complete incorporation and organizational documents.
- Complete subscription agreements, membership agreements and offering memoranda.
- Complete licensure and capitalization.

With various financial, legal, legislative and risk management challenges facing construction companies today, it may prove wise to investigate alternatives to traditional insurance programs. Forming or joining a captive may offer the flexibility and control necessary to remain competitive and secure.

About Beecher Carlson

Beecher Carlson's Construction Risk Management Practice is recognized as a leading provider of construction risk management solutions for residential builders and developers, project owners, contractors and suppliers.

Using an integrated approach to the financial tools available in risk finance, Beecher Carlson can deliver both traditional and non-traditional risk management solutions. We are distinguished for our captive management services, having experience in each of the major domiciles that spans more than two decades. Our expertise in captive programs is comprehensive, ranging from feasibility consulting and design through implementation and maintenance and spans a range of solutions including Rent-a-Captives and Parent-Owned Captives to insure construction risks.

In addition, Beecher Carlson construction specialists are experts in the design of risk management programs to meet the specific needs of today's increasingly popular design-build project delivery systems. We offer wrap-up programs, both Owner Controlled Insurance Program (OCIP) and Contractor Controlled Insurance Program (CCIP), which are designed to substantially reduce the costs associated with a construction project when compared with traditional insurance programs. We also provide a comprehensive array of core property and casualty coverages to protect against most types of construction risks.

For additional information about construction risk management and captive insurance programs, contact Beecher Carlson today.

