

# Construction—U.S.

Market Update Spring 2010



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2009 was another challenging year for the construction industry due to the continued weak economy. Overall, the insurance market remains generally soft due to overall improved profitability in 2009 as a result of improved investment gains that helped offset lower premiums from the continued soft market, lower exposure base, and below-normal catastrophic losses.

## Federal Stimulus Funding Bust

The federal government's 2009 stimulus plan did little to produce construction projects as initially projected. Much of the stimulus monies allocated in 2009 were spent on smaller re-paving, sewer, or sidewalk improvement work spread across thousands of projects in the U.S. Furthermore, it generally had been anticipated that there would be significant growth in Public Private Partnership (P-3) opportunities in 2009, which did not materialize.

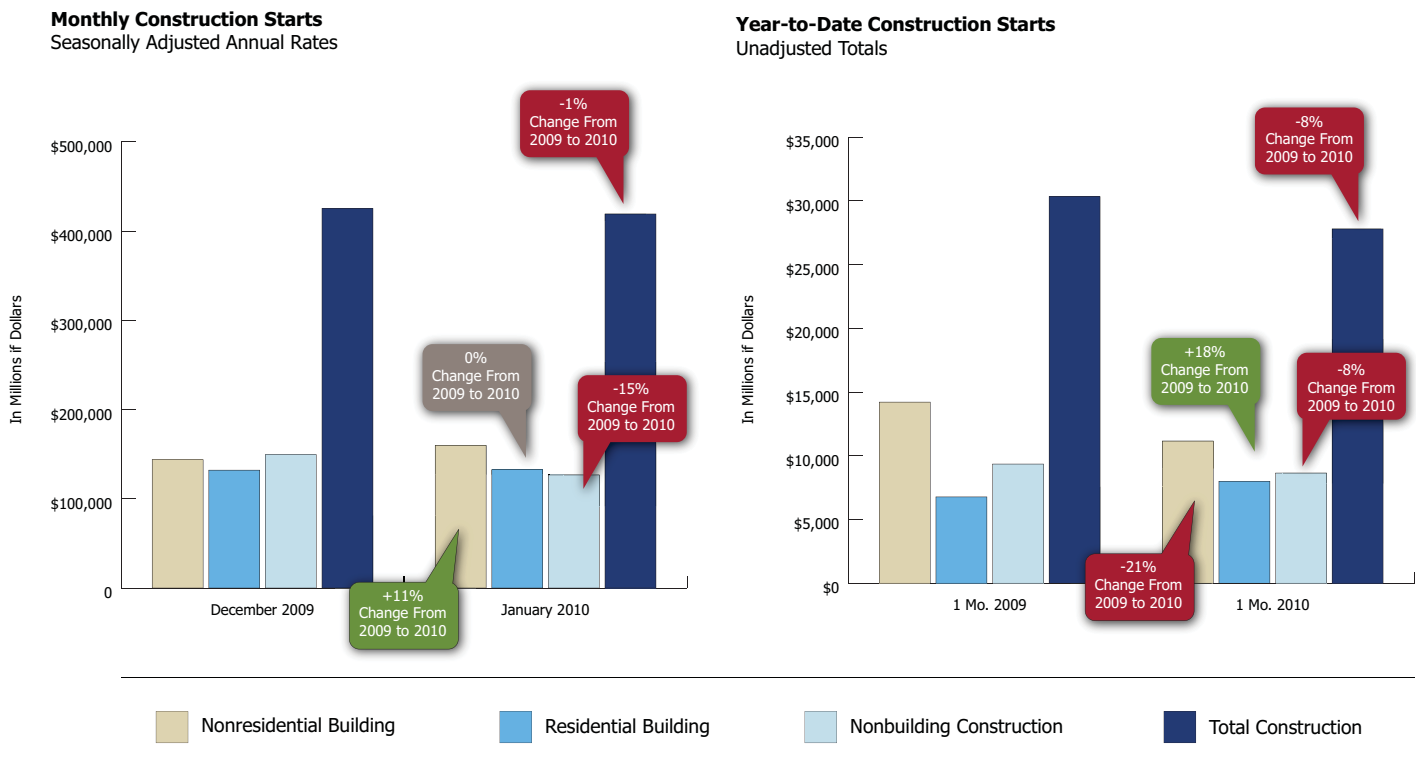
## Construction Forecasts and Trends

With cautious optimism, there appears to be signs that the credit markets are improving in some construction segments, and 2010 may be a better year for new project opportunities than 2009. Nevertheless, it is likely that the residential and general commercial segments will continue to be hindered by an overabundance of inventory and persistent credit strain, respectively.

McGraw-Hill Construction Research & Analytics reports the value of new construction starts reduced only 1 percent in January. The slight loss was due to a decline in nonbuilding construction after this sector’s improved performance last December. The bright spot is in the residential building sector, which produced an 18 percent gain and is expected to increase in 2010 subject to continued low mortgage rates and incentivized homebuyer tax credits.

### January 2010 Construction Starts—Monthly and Year-to-Date Summary of Construction Starts

Prepared by McGraw-Hill Construction Research & Analytics



### Construction Market

The market continues to be soft for most property and casualty lines of coverage. The exception is Workers’ Compensation where, in general, rates are holding steady in most states. However, California is seeing most insurer’s file rate increases while ignoring the State Insurance Commissioner’s denial of recommended “advisory” rate increases from the state’s Workers Compensation Insurance Rating Bureau (WCIRB). Nevertheless, low consumer demand and continued insurer appetite are perpetuating the soft market.

At the end of the first quarter of 2010, we are seeing even softer pricing from the excess liability, environmental, professional, and property as well as the wrap-up markets. Notable causes for these lines producing softer pricing are due to new market entrants, aggressive marketing in combining environmental and professional coverages, and the reinventing of AIG, which rebranded itself as Chertis Insurance.

## Surety Environment

### Outlook for Contractors and Work in 2010

Commercial work, especially office and retail, fell off sharply in 2009 and is expected to remain that way in 2010. Industrial work and multi-family residential work has slowed down, while new home construction is still bouncing off its lows in its now four-year decline.

This will put pressure on trade contractors to explore the public bid arena. This puts added downward bidding pressure on the few public projects that are let, as long as these new entrants to the public works game can get the necessary bonding.

### Outlook for Surety Credit in 2010

Surety companies are expecting their contractor backlogs to be less than they were in 2008. New work was hard to find during this Great Recession. Going into a new year with a weak backlog means that the new work might have to be bid aggressively, perhaps even too aggressively, leading to possible job-performance losses down the line.

But for the moment, for existing accounts, we expect that the standard sureties will continue to extend their normal credit to their established clients, even if they show a bottom-line loss for 2009, as long as the balance sheet stays healthy.

Contractors looking to get into the public bid market will have to quickly come up to speed to the same reporting and financial disclosure requirement that long standing public works contractors have had to conform to. This could be problematic for some contractors looking to get into public work. There are a number of sureties that have some flexibility in their reporting requirements, as long as additional security is provided, the desired work program makes sense, and the surety and the management/ownership team share common perspectives.

Whether a large existing public works contractor or a new entrant to public work, getting and keeping surety credit will be tougher than in the past. That mirrors what is going on in the banking and credit environment overall. Specifically for surety, anticipate more questions before a bid is approved and note that more questions will be directed to the health of the balance sheet.

To get the most surety credit for 2010, keep the communication open and regular with the surety and with the surety broker. Anticipate missteps or miscues. If something does arise, develop a plan to clear it up. Communicate that plan before the financial results are released. Keep an eye on collections and on cash flow and avoid relying on revolver credit from the bank to cover short-term working capital needs.

## New Markets and Financial Products

Earlier this year, Arch Insurance unveiled two new product offerings to the construction market. The products from Arch provide a potential alternative to similar coverages offered by a few carriers within the insurance marketplace.

### Subcontractor Default Insurance

Arch Insurance Company introduced Subcontractor Default Insurance to the construction industry in early 2010. The coverage is underwritten through Construction Risk Underwriters, and their target market is contractors with \$100,000,000 in subcontractor volume. Risk engineering services and dedicated claim adjusters will be provided by Arch Insurance.

The initial capacity for the coverage provides a \$15,000,000 each-occurrence limit with aggregate limits available from \$30,000,000 to \$45,000,000. It is expected that Arch's initial capacity will increase through 2010. No minimum volume or minimum premiums will be required.

### Homebuilder Liability Insurance

Arch Specialty Insurance Company, through Construction Risk Underwriters, has also begun offering a Homebuilder Liability insurance program targeted at the medium and larger builders. Optional limits of liability are available and arrangements can be made for Following Form Excess coverage. The policy may also be created as a wrap-up program.

Liability insurance will be provided for all builder operations, both during and after home completion. Completed operations coverage will be provided for ten years or until the potential warranty expires (whichever is later). If a warranty is issued on a home, the policy responds to the cost of repairing the defects covered under the warranty.

Also unique and beneficial is the payment of premium requiring a deposit and monthly or quarterly reporting of values, thus providing the optimum in cash flow management for the client.

### New Collateral Products

New alternative collateral mechanisms have emerged as creative options to the typical Letter of Credit or cash as security for large loss-sensitive deductible programs.

Travelers debuted their new collateral product last August 2009—the Money Market Collateral Account. As the name suggests, this option will allow insureds to post collateral in the form of NAIC-approved money market funds or highly liquid government securities using Master Pledge and Security and Control Agreements. Highlights of the program are:

- ❖ \$1,000,000 minimum total collateral requirement (targeted at national accounts, construction, and Discover Re business).
- ❖ Minimum credit rating of “B” on Travelers’ scale to qualify.
- ❖ While this collateral will be nonworking in nature, it will hold the same security value as a Letter of Credit (LOC) to Travelers (i.e., no surcharge).
- ❖ This collateral option will be “all-or-nothing”: if choosing the money market accounts option, the entire security requirement must be posted in that form (no mixing and matching with LOCs).

### Hybrid Collateral Product

Hartford Insurance introduced its Hybrid Collateral option, which is a blend of prefunded cash collateral in conjunction with a small LOC. The cash collateral is used to pay losses on a monthly basis. Once the cash collateral has been depleted, then the insured is billed monthly for paid losses.

Other collateral items that could potentially be available are a trust + LOC option (this would be on a standby collateral basis, and paid losses would continue to be billed monthly) as well as a prefunded deductible program (which has a higher cash collateral pay in). In the prefunded deductible scenario, paid claims are deducted from the cash fund on a monthly basis. There is a lower deductible premium on the prefunded deductible as a result of the higher cash pay in.

Other markets offering creative collateral alternatives include ACE, Chartis, and Zurich.

### Case Developments

#### Architex Association, Inc. vs. Scottsdale Ins. Co.

In February 10, 2010, the Mississippi Supreme Court ruled that a Commercial General Liability Insurance (CGL) Policy “extends coverage for unexpected or unintended property damage resulting from the negligent acts or conduct of a subcontractor.” In the

case of *Architex Association, Inc. v. Scottsdale Ins. Co.*—2010 Miss, the general contractor was sued for a host of defective work issues caused by their subcontractor that led to property damage to a Comfort Inn Hotel under construction.

In the decision, the court found that the alleged defective work was accidental and unintended. This latest ruling on this business risk issue falls in line with the majority of states that recognize that allegations of defective work meets the definition of an “occurrence” under CGL policies.

### Ponok Realty Corp vs. United Specialty Insurance Company

In January 2010, the New York Supreme Court provided further clarity on late notice within the State. The case of *Ponok Realty Corp vs. United Specialty Insurance Company* outlined the issue of the insurance carriers needing to show prejudice, if late notice arose. A 2008 amendment to the New York Insurance Law 3420(c) (2) (A) provided that where “an insurer alleges that it was prejudiced as a result of a failure to provide timely notice, the burden shall be on the insurer to prove it has been prejudiced.” The decision verified that the 2008 Amendment be applied to policies that were issued on or after January 17, 2009. Thus, losses that have occurred on or prior to the January 17 date will be subject to the old law and timely notice will need to be shown.

### Forecast Homes, Inc. ET AL vs. Steadfast Insurance Co.

In *Forecast Homes, Inc., et al v. Steadfast Ins. Co.* (2010 CA. App. LEXIS 172, 4th App.), the court held that the additional insured general contractor could not access Commercial General Liability coverage unless the named insured subcontractor paid the self-insured retention (SIR). Forecast Homes—the developer and general contractor—contractually required all of its subs to add Forecast as an additional insured under their general liability policies. Over a dozen subcontractors were insured by Steadfast Insurance Company under two different versions of endorsements to the general liability policies.

Forecast was served with five different lawsuits alleging property damage and tendered its defense to Steadfast. It should be noted that the subcontractors were not directly named by the plaintiff in the lawsuit. Steadfast denied Forecast’s tender on the ground that the SIR was not satisfied and *only the named insured could satisfy the SIR and thereby trigger Steadfast’s duty to defend Forecast.* The Courts agreed with this position, holding that it was not against public policy.

## Summary

The construction insurance market should remain soft to level through 2010. Insurance companies are better capitalized compared to other industries, which will allow them to continue to offer competitive programs and plenty of limit capacity.

Markets will continue to aggressively pursue new business and hold the line on existing business. Contractors should be prepared to provide more underwriting data and answer more exposure questions from a more disciplined underwriting market environment. As stated in previous Market Updates, regardless of the cyclical volatility of the insurance market, disciplined risk management should remain resolute to avoid complacency during softer markets.