THE CONTRACTOR LIABILITY INSURANCE
COST AND COVERAGE PROBLEM
- SOLUTIONS TO IMPROVE

August 2005
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CHAPTER 1: EXECUTIVE SUMMARY
Problem Statement

*Increasing Tort and Liability Insurance Costs are Forcing the Construction Industry, the Public Taxpayers and its Other Consumers into a Crisis.*

1. Construction industry insurance premiums have increased more than 50 percent over five years, as reported by a representative sample of 300 construction firms involved in the study. Findings reveal that 75% of the firms had zero general liability claims but still incurred the premium increase. Study findings determined that this hyperinflation has unnecessarily inflated construction costs for the user and taxpayer by $20 billion each year.

2. Construction industry insurance coverage has decreased over five years. Respondents state that despite a dramatic increase in their premium, they are receiving far less coverage than they had five years ago. This unnecessarily exposes the construction user and taxpayer to risks for which their contractors have no coverage. Contractors state they have had to abandon work in areas for which they cannot get coverage or risk facing the losses. The study reports that the impacts to the business environment have been severe.

3. Study respondents report that construction industry insurance limits of liability have been reduced as a consequence of hyperinflation. This unnecessarily exposes the construction user and taxpayer to risks for which their contractors have insufficient limits of liability protection.

4. The drastic increase in construction tort activity by an aggressive plaintiffs’ bar is forcing insurance companies and contracting firms to absorb enormous legal and settlement costs. Excessive awards received for court decisions and the ease of securing settlements for mold, multifamily construction and other related claims have encouraged the legal community to specialize in construction litigation.

5. The insurance industry lacks the information it needs about contracting firm operations and practices to create effective insurance solutions. Historically, the insurance industry paid insufficient attention to the risk they insured in the construction industry, in some cases not charging appropriate premiums. However, after 9/11 insurance companies began to re-evaluate
the terms in nearly all policies. They initiated significant price increases and reduced coverage as a short-term financial fix. These practices were implemented without a full understanding of the contracting business.

6. The construction industry is a vital component of the U.S. economy. According to Census data; it employs five percent of the total U.S. workforce, represents nearly 500,000 firms with over three million employees, and contributes more than $750 billion to the economy.

Solutions-Recommendations

A combination of tort reform, insurance industry partnership solutions and individual contracting firm actions will have the greatest impact on liability cost and coverage for the construction industry.

1. Federal Actions: The importance of the construction industry to our national economy and the level of the industry’s interstate commerce create a need for a federal solution. This solution must:

- Promote elements of tort reform already in discussion in areas outside the construction industry. These elements include limits on damage awards, elimination of the collateral source rule, a change to proportionate liability rules, and the allowance for periodic payment of fees. It should also support existing tort reform initiatives such as the Lawsuit Abuse Reduction Act (LARA) already introduced in the U.S. House of Representatives as bill HR 420.

2. State Actions: State tort and other reform initiatives are not consistent from state to state, and many states do not have critical reform measures in place. A unified state solution is needed to:

- Create a model state reform package, which at minimum should include a statute of repose of less than 10 years and a notice and opportunity to repair rule beginning with a 60-day time frame. These two measures are critical to validating claims.
- Continue to support other reform measures such as comparative negligence and limits on attorney fees and damages.
3. **Insurance Industry Actions:** The basis for a solution within the insurance industry requires the construction industry to view it as a partner and work with it to highlight contractor insurance needs, practices and performance quality. Critical actions include providing education about contractor risks, developing insurance policy training for firms, leveraging company safety records, promoting the recovery of the reinsurance industry, and supporting legal reform.

4. **Contracting Firm Actions:** Tort reform and insurance industry partnership will help create a favorable environment for general liability insurance. Individual contracting firms can take the following actions to help contribute toward developing a sustainable solution:
   - Perform contract, project and legal reviews on annual basis.
   - Participate in legal and insurance industry training and education sessions.
   - Increase documentation, reporting and communication regarding risk, project performance, improvements and claims.
   - Support tort reform and insurance industry partnership efforts.
Purpose

The purpose of this study is to 1) provide fact-based, actionable recommendations to overcome the excessive cost and poor availability of insurance for contracting firms, and 2) demonstrate the corresponding negative economic impact on the public (taxpayer – consumer – construction user). Numerous factors, including excessive tort activity and settlements and actual state operating guidelines, have influenced the insurance crisis we observe today. In order to determine the most effective solution(s), this research program has analyzed the current realities of and impact upon contractor project work, total project costs and burden to the construction user and taxpayer. With a valid information base, this project has defined the benefits and drawbacks of various solutions and offers the most meaningful specific and collective alternatives for the industry.

This research indicates that this problem is universal. Contractors with no history of claims or on-site safety problems are increasingly named in lawsuits and watch helplessly as the insurance companies settle non-economic damage claims. Insurance companies in some states are raising rates without waiting for problems to develop. Detailed study findings reveal how significant the rate increases are and how disproportionate they are to actual claim frequency. The study information demonstrates how higher premiums and reduced coverage create operational difficulties for contractors and an increased financial burden for consumers and taxpayers.

Contributors and Supporters of the Study

Funding for this study was made possible through a joint effort by numerous construction contracting associations. A high level of involvement was demonstrated by these associations as well as individual member and non-member firms. The following groups have worked in tandem with Ducker Worldwide to ensure fast and efficient movement through project milestones:

<table>
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<th>Sponsoring Associations</th>
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<td>Electrical Contracting Foundation</td>
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<td>Roofing Industry Alliance for Progress</td>
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<tr>
<td>Plumbing-Heating-Cooling Contractors - National Association</td>
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<tr>
<td>National Utility Contractors Association</td>
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<tr>
<td>American Subcontractors Association</td>
</tr>
<tr>
<td>National Subcontractors Association</td>
</tr>
<tr>
<td>Mechanical Contractors Association of America</td>
</tr>
<tr>
<td>Air Conditioning Contractors of America</td>
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<tr>
<td>Finishing Contractors Association</td>
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<tr>
<td>Painting and Decorating Contractors Association</td>
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<tr>
<td>The Associated General Contractors of America</td>
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Study Overview

A formal process drove the study. Interviews were conducted with over 300 contractors, industry personnel and insurance experts. We employed several research methodologies, of which comprehensive telephone discussions were the primary and most useful method. The need for telephone interviews was driven by the requirements of the sample size and the need to ensure regional coverage amongst a diverse respondent base. Several conditions for the research process are important to note:

- All interviews were conducted in-house by Ducker Research personnel.
- Firm owners, management personnel and industry participants were pre-screened and pre-qualified with regard to their experience and knowledge of related insurance considerations and liability issues.
- Regional monitoring was used to maintain a balanced segmentation of input.
- Contractor type and size was balanced to ensure consistency of analysis across categories.
- Both quantitative (fixed, objective) and qualitative (subjective) techniques were utilized.

Quality control procedures were used throughout interviews and analysis phases to ensure accuracy and consistency.

An appropriate volume of inputs was received from each group by utilizing proper research methodologies and sampling techniques.

Ninety four percent of the respondent sample (nationally representative contractors in terms of firm type, size and region) stated that rising premiums and high insurance expenses are a primary concern for their business. Insurance premiums, which have increased more than 50% on average over the past five years, have created a universal problem for contractors throughout the nation.
Premium increases are not the only insurance issue— exclusions and limitations are greatly affecting the ability of contractors to acquire necessary insurance coverage. Contractors report that they are no longer able to engage in projects that in the past were very appealing. They report that their insurance policies are now written with substantial exclusions even at the higher prices. They have to pass on these additional costs to consumers and taxpayers in the form of higher construction prices. Detailed study findings show that these insurance trends have increased direct costs to construction consumers by several billion dollars over the last five years.

Tort activity is also exerting tremendous influence over contractors’ ability to secure sufficient coverage. Research shows that regardless of actual claims or claim frequency, the average contractor has seen an increase more than 50% over the last five years. Findings from this portion of the study show that contractors have seen an increase in litigation regardless of actual claims records and are overwhelmed by the rapidly increasing level of tort activity. Contractors with no claims over the past five years have still had to endure premium increases because of newly elevated perceptions of risk.

This research study finds that changes in insurance have substantially impacted the contractors’ competitive environment, with many contractors noting an evolution in the way their markets function. Problems caused by excessive litigation, dramatic price increases and the inability to protect themselves against any type of claim impair contractors’ ability to compete. The combined effect of these conditions have left contractors concerned over their ability to stay in business.

These conditions necessitate a call to action. This study provides detailed information about tort and legal reform, the need for an insurance industry partnership, and education and training opportunities for construction users. These components are thoroughly covered in the Final Conclusions and Recommendations portion of this document.

**Outline of Key Objectives**

The primary goal of this research program is to provide meaningful solutions to the current insurance liability problems and recommend actions by individual firms or the collective organization. A critical component is to examine alternative remedies, including other types of insurance policy solutions, tort reform and model language for use at state and federal levels.
Testing Hypotheses

This study poses a set of six core hypotheses, each with the purpose of quantifying a specific impact in order to identify and analyze the extent to which insurance and liability-related issues affect the construction industry. The core areas of research have been designed to address the following hypotheses and test the degree of their relevancy to the contractor. The hypotheses for testing are:

**Hypothesis 1** – Insurance premiums have grown at an alarming rate over the last five years regardless of contractor type, size, region or performance.

**Hypothesis 2** – Coverage has not improved despite the sharp premium increases. New exclusions and limitations are forcing contractors to abandon work in certain areas where they cannot obtain proper insurance coverage. This encourages the construction user to employ uninsured contractors because of their lower cost bids for projects.

**Hypothesis 3** – Several factors independent of contractor control are increasing the frequency at which claims are being filed and settled against contracting businesses.

**Hypothesis 4** – Contractors are experiencing an evolution in their competitive environment, which makes conducting their business significantly more difficult.

**Hypothesis 5** – If valid, the combined effects of hypotheses 1 – 4 are dramatically increasing the cost of construction, impacting the overall project cost.

**Hypothesis 6** – Contractors are passing increased insurance expense on to their customers, raising the cost of construction projects for consumers, building owners and state and federally-funded improvement initiatives.

Through high-level research and investigation, the process addressed the validity of each of the preceding hypotheses and identified the most appropriate mix of remedies.

Identify and Evaluate Potential Remedies

The on-going crisis has driven contracting firms and some states toward creative solutions and proposals. Comprehensive research of existing and proposed solutions, including those enacted by single firms as well as state or national efforts, has been completed. Ducker assessed the benefits, drawbacks and feasibility of many different solutions to successfully impact contracting firms.
Create a Solutions Program

Ducker offers a recommendation of the best combination of remedies to pursue. Our recommendation is based upon the analysis of the data gathered and our solutions identification methodology.

The solutions program provides actions that can be taken by individual contracting firms which operate locally but also support future efforts that may include model language for federal recommendations, national programs or other collective efforts. This is the first step in a total effort to implement reliable solutions.
CHAPTER 3: ASSESSMENT OF LIABILITY ISSUE IN INDUSTRY
Definition of Current Problems and Limitations

In-depth interviews with over 300 contractors in all regions of the country were conducted by Ducker Worldwide to provide a current, accurate snapshot of the construction industry. The information gathering phase was conducted from September 2004 through February 2005. The information was entered into databases and analyzed using proprietary modeling techniques. This technique is pivotal in understanding general market characteristics and acquiring both broad and segment-specific information about how the industry functions today. This study followed a formal process to ensure that the information was comprehensive and would pass testing for validity and reliability.

Contractors who participated in the project demonstrated a high level of involvement and were forthright about their firms’ current status and the industry in general. Each contractor engaged in an extensive 30-60 minute interview with a Ducker team professional. Contractors were instructed to have access to their insurance records for the previous five years to enable them to report on price fluctuations, alterations in coverage or any changes to the contract (in language or structure) that affected their business. Follow-up phone calls to some contractors were used to acquire more extensive information in areas that were of particular interest in the study. The findings were analyzed in aggregate, and the data can be considered representative of the population.
Each interview began with an unprompted discussion about what problems, if any, the company has with regard to insurance or insurance coverage. This was done to gain an unbiased assessment of a contractor’s current insurance situation. Contractors were asked, “What are the top three problems or concerns that you have with regard to your current insurance needs?” Eighty one percent of respondents, regardless of contractor type, region, size, or performance, indicated that rising costs of premiums are a tremendous concern for their business.

Exclusions are also a growing concern. Contractors are finding that their policies are now being written with exclusions for residential construction, mold, asbestos and additional areas. The “other” category of insurance concerns includes such items as fewer companies willing to insure, the inability to continue providing sufficient employee medical and dental coverage, differing requirements, and complex policy language with high levels of ambiguity.
These concerns provided the foundation for analysis. Interviews with nine association types from all regions of the country showed that concerns about insurance premiums and coverage are warranted. When given this opportunity to express their frustrations, contractors spoke at length about how these issues affect their ability to operate their businesses. This analysis confirms that these issues have a significant national impact and are causing contractors a great deal of stress.

Respondent verbatims provide further insight into the nature of these concerns:

“Prices have gone so high that we are sometimes forced to turn down jobs that would otherwise be very appealing just because of what it may do to our insurance.” - Florida

“Insurance has gotten so expensive that there are a lot of companies going out of business because they can't afford the coverage.” - California

“We can't bid on residential projects anymore because no one will cover us for it. We used to do a lot of residential work.” – Illinois

“I won't even consider residential construction anymore. According to workman’s compensation, if an employee falls off the second rung of a ladder, I am automatically negligent regardless of the worker’s mistake (even if he is drunk). With legitimate claims I have no problem, but the system has gotten totally abused.” – New York (Absolute Liability State)

Complexity of Policies and Understanding by Contracting Firms

A problem exists with the complete understanding of project contracts and all of the associated risks incurred by contracting firms. The study sought to determine how well equipped contractors are to compare the requirements of the contract to the insurable risks covered in the policies. When interviewed, only 50% of contractors were aware that some insurance agencies offer contract reviews as part of their service. More importantly, only 54% of the contractors aware of this service took advantage of it. This means only one quarter of contractors interviewed have project contracts reviewed by their insurance agents. Many contractors stated that they don’t have time to engage in a full contract review before each project or that they review only projects over $100,000.
This finding indicates that contractors may be largely unaware of the specific provisions of contracts that directly affect them. This is highlighted when we review hold harmless clauses and additional insured problems. Risk management personnel at multiple insurance companies indicate that contractors should seek qualified assistance to assess the requirements of project contracts as they relate to the complexity and vagueness of policy language. In the bidding/opportunity selection stage, contractors need to act as their own advocates when evaluating and examining the structure of project contracts.

**Liability Insurance Premium Increases**

Contractors were asked to provide their yearly premiums during the period from 1998 – 2003 to appropriately gauge fluctuations in insurance premiums and note particular problems for liability insurance. Respondents were asked, “Have you noticed significant increases in your premium amounts during the last five years?”

![Figure 2](image)

Significant Increases in Insurance Expense

(Percent of Contractors)

<table>
<thead>
<tr>
<th>Category</th>
<th>Percent</th>
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</thead>
<tbody>
<tr>
<td>Yes</td>
<td>94%</td>
</tr>
<tr>
<td>No</td>
<td>5%</td>
</tr>
<tr>
<td>Unsure</td>
<td>1%</td>
</tr>
</tbody>
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Ninety-four percent of contractors surveyed stated they faced considerable rate increases during this period. The responses ranged from minimal increases of 10-20 percent to extreme increases such as 250 percent. Respondents were then asked to report their actual premium expense from 1998 versus their expense in 2003. An insurance ratio analysis was used to determine the degree of premium increase that contractors faced.
The insurance ratio is defined as insurance expense as a percent of total revenue. This analysis is useful in reporting premium growth independent of changes in the company over time. This ratio eliminates growth or contraction in a company’s revenue and reports only what portion of revenue was spent on total insurance premiums. Respondents reported their revenue and insurance expense for the years 1998 and 2003. The insurance ratio for each year was then analyzed to determine the degree of change. Again, this technique eliminates premium fluctuations that occurred as a result of growth or reduction in business volume. It is an absolute indicator of change in premiums. As anticipated, companies of varying size reported different insurance ratios.

**Figure 3**

**Change in Insurance Ratio**

*(Insurance Expense as a Percent of Total Revenue)*

![Figure 3](image)

Note: The above percentages are averages obtained from analyzing 12 different contractor types in all regions of the United States. Numbers are not intended as exact figures.

When comparing the numbers reported from 1998 to those reported for 2003, you can see that overall contracting firm insurance premiums increased by more than 50 percent. The average insurance expense as a percent of total revenue rose from 2.5 percent in 1998 to 4 percent in 2003. These findings support the theory that construction contractors are dealing with increased premium expense, regardless of any differentiating characteristics. The problem therefore is universal, requiring broad-level attention and solutions. Increased premium expense is the most dramatic problem in the industry, but it isn’t the only insurance-related concern.
**Hypothesis #1 – Valid**

*Insurance premiums have, on average, increased by over 50% during the last five years regardless of liability claim incidence. The Insurance Ratio Analysis confirms the greater than 50% increase.*

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**Reduced Availability of Coverage**

The research study also focused on identifying any shifts in insurance coverage during the past five years. Respondents were interviewed at length to determine any trends in insurance coverage and the degree to which exclusions have impacted their business. The overwhelming response was that contractors are “paying more for less”. They report that policies are now written with substantial exclusions. The most common exclusions are mold and asbestos. However, insurance companies have also dropped several other types of coverage, including certain pollution and hazardous material liabilities, water leaks, and numerous trade-specific risks. Information on reductions in coverage is detailed later in this report, and particular interest is paid to exclusions for residential construction, mold, and the dramatic increase in the frequency of mold-related claims.

Reducing their liability coverage is one way businesses are trying to cope with premium increases. But this may have potentially dangerous ramifications. According to a recent study, the average total liability limits purchased by businesses fell in 2003 for the second consecutive year. Small and mid-sized businesses in particular are skimping on the amount of insurance they purchase, presumably to avoid higher insurance premiums. Firms with revenues under $200 million decreased limits purchased by 18 percent between 2002 and 2003. Firms with revenues ranging from $201 million to $500 million, the segment most vulnerable to a bankrupting loss, slashed limits by nearly 10 percent.\(^1\) Cutting back may at first seem a rational response to higher prices, but any reduction must be considered against the company’s level of exposure, which in some areas has tripled or even quadrupled in recent years. Viewed in this light, reducing liability coverage seems reckless.\(^2\)

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\(^1\) Limits of Liability 2003 Coverage Adequacy: Achieving a Delicate Balance, Marsh, Inc.  
But many contractor firms find themselves with few options. The problems in the industry have reached a crisis. As industry participants grapple with increasing insurance expenses, their customers are feeling the impact of rapidly increasing construction costs. Residential, commercial, industrial and municipal construction projects over the last five years have seen a significant increase in overall project costs. Contractors’ rising insurance premiums and lack of appropriate coverage affects people at all levels within the U.S. economy, whether directly as a construction purchaser or indirectly through higher-taxes for government-funded projects.

Verbatim comments help provide context.

“There is less coverage, more exclusions, higher deductibles and the insurance companies are keeping more things out of the policies.”

“There are a lot more exclusions in the policies today than there were five years ago, such as flat single ply [roof] that no one wants to insure.”

“We have to forego doing many projects because we can’t afford to take on the risk. We aren’t covered in many areas that we used to be and the ones that we are still covered for have gone up significantly.”

**Hypothesis #2 – Valid**

_**Contractors have reported significant reductions in their coverage. The market reaction is causing a situation where consumers are served by uninsured or underinsured contractors.**_
Increased Legal Activity and Settlement

Much attention has been given recently to the growing number of claims and the frequency at which individuals prefer litigation over non-litigious alternatives. In an effort to assess the impact of this trend on contractors, construction consumers and taxpayers, the study gathered data from individual contractors to quantify claims frequency and calculate the associated expense. The following claims discussion provides statistically-supported information on the scope of the problem and the impact to the industry and the economy.

- Regardless of quality control measures, worksite conditions or worker safety records, contractors report increasing claims per dollar of construction, litigation in a higher percentage of those additional claims, and skyrocketing insurance premiums.
- Despite the fact that 75% of contractors examined during the study had not had a general liability claim, they have still had to bear the premium increase due to the associated risk.

Case Example

In 2003, Jon Olivieri, a framing subcontractor in Sacramento, saw his construction insurance premium skyrocket 535 percent, from $85,000 to $540,000, despite a near-spotless record in his 19 years in the business. The premium hike added so much to his costs, averaging about $3,500 more per house, that one big account—Dunmore Homes, worth $12 million in revenues to Olivieri—stopped doing business with him. Olivieri is one of thousands of small to medium-size contractors in California who are seeing their businesses go south after enduring more than a decade of flimsy lawsuits alleging construction defects. These lawsuits have driven insurers from the state and put a virtual halt to condominium construction. In 2000, insurers paid out $2.95 for every premium dollar they took in.

Additional claims data as well as conclusions for Hypothesis #3 are provided in the “External Factors Impacting General Liability” section.

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3 Insurers’ Rate Hikes Hammer Builders, SACRAMENTO (Cal.) BUS. J., May 2, 2003
4 Housing Constriction: Spurious Lawsuits are Strangling California Construction Industry. Trial Lawyers Inc. com
Contractor Claims Assessment

Contractor firms were analyzed for the total number of claims they experienced during the period from 1998 through 2003. When analyzing this information, several important factors were identified. First, 38% of the companies had zero claims in the five year period. Additionally, 72% of all contractors under study have fewer than five total claims in the period under examination. And specific to the issue of general liability, 75% of the companies analyzed did not have any general liability claims during the last five years. Despite these records of claim-free performance, contractors have incurred an average premium increase of more than 50%.

Respondents indicate that the industry has seen an increase in claims in multiple areas. Respondents were asked, “Are there any specific areas in which you feel that you are being exposed to increased litigation more now than you were five years ago”? Many contractors have reported that despite quality performance, the percent of litigated claims has increased, most likely due to growth in high jury awards for non-economic damages which ignore collateral source of payments already received. These awards have grown, despite USDOL records that show that accident severity/frequency has dropped sharply during the corresponding period. Those contractors have concluded that they underwriting losses sustained by the insurance companies during the corresponding period have been subsidized by the economic value of improved safety results. As such, the unprecedented construction user-contractor emphasis on safety and risk management during the corresponding period has served only to reduce the rate at which insurance premiums are increasing the cost of construction. The following areas have been a growing source of concern due to the increasingly litigious nature of the industry:

Contractor Concerns

- Mold
- General Liability
- Defect Claims
- Health Insurance
- Worker’s Compensation
- Third-Party Suits
- Residential Coverage
- Risk Transfer
Utilizing modeling techniques to determine the impact of specific problem areas was the next step to better understand the actual claims occurrence over the last five years. Contractors argued that despite good performance and low claims, they incur the same insurance increases as lower quality or higher risk counterparts.

The data was analyzed for claim type, frequency, and settlement outcome to provide a broad understanding of how industry contractors are affected. The intention was to determine the rate of claim growth and compare it to the contractors’ perception. In addition, an understanding of where the high levels of reported claims exist is critical to determining how they impact the overall industry. The following chart addresses claim activity from the 300 contractors interviewed during this study. Note that the sample is evenly distributed by firm type, size and region.

**Figure 4**

*Total Insurance Claims by Company*

<table>
<thead>
<tr>
<th>Number of Claims</th>
<th>Percent of Contractors</th>
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<tbody>
<tr>
<td>0</td>
<td>38%</td>
</tr>
<tr>
<td>1</td>
<td>13%</td>
</tr>
<tr>
<td>2</td>
<td>9%</td>
</tr>
<tr>
<td>3</td>
<td>7%</td>
</tr>
<tr>
<td>4</td>
<td>5%</td>
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<tr>
<td>5 to 10</td>
<td>11%</td>
</tr>
<tr>
<td>11 to 15</td>
<td>5%</td>
</tr>
<tr>
<td>16 to 20</td>
<td>2%</td>
</tr>
<tr>
<td>21 and Over</td>
<td>10%</td>
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The total claims frequency analysis shows how many claims companies had during the last five-year period. This analysis includes all types of claims and identifies what percentage of the companies fall into each category. The analysis shows that the majority of contractors under study have very low claims incidence. Thirty eight percent of the companies studied had zero claims during the period; 72% had fewer than five total claims. Yet, as reported earlier, the average insurance premium increase during the past five years was 50%. According to this study’s findings, most of the contractors that have zero or a very low claims incidence find themselves sharing the burden of firms with much higher levels of claim incidence.

We next wanted to assess the frequency and occurrence of worker’s compensation versus general liability claims. Respondents were asked to categorize the total number of claims they received during the last five years by claim type and frequency.

**Figure 5**

*Type of Claims During the Last Five Years*

The pie chart displays the breakdown of these contractor claims by type. Worker’s compensation and general liability claims represent 66% of all claims from 1998 to 2003. The effects of worker’s compensation may be creating an evolution in the way that general liability cases are handled. For example, contractors stated that in many cases, there were few true general liability claims. All the general liability claims they experienced were third party over cases that arose out of worker’s compensation claims.
Automotive-related claims were the third most frequently mentioned type of claim, comprising 17% of claims. The “other” category includes claims for property and equipment, fire, theft, storm damage, power surge and others. To determine the average number of each type of claim received by the respondents, the 140 companies without any claims were removed from the total. Statistical analysis was then performed on the remaining 160 companies to determine the average frequency of each type of claim. The following chart depicts the average number of claims by type from the included companies.

**Figure 6**

**Frequency of Claim Type**

*1998 - 2003*

- **All Others**: 4.0
- **Automotive**: 3.8
- **General Liability**: 7.2
- **Worker's Compensation**: 7.9

It is important to note that general liability and worker’s compensation claims have a similar frequency of occurrence: 7.2 per company for general liability and 7.9 for worker’s compensation. These figures conclude:

- General liability and worker’s compensation are the dominant claims.
- The ease and frequency of settlement for worker’s compensation may have created a “plaintiff friendly” system that is now spilling over into general liability.
- Even now, general liability claims are settled like worker’s compensation issues.

The critical point is that general liability claims are becoming much more prevalent than in the past. These factors may be encouraging an environment where no-fault worker’s compensations concepts are creating a thirst for “jackpot justice” in general liability claims.
Number of Liability Claims by Company Size

The preceding information examines the average number of claims reported by each company under study. We observed that significant variation exists between the companies. In order to understand these variations, we examined multiple potential causal factors to determine if similar characteristics exist that could better characterize the higher-risk companies in the construction market. The most significant finding from this part of the study is that companies have greatly different numbers of insurance claims based on their size (annual revenue). The companies were analyzed to determine how many liability insurance claims they have per $1 million in revenue. The categories used to analyze the data are “less than $1 million,” “$1 to $5 million,” “$5 to $10 million,” and “greater than $10 million.”

![Figure 7](image)

Number of Liability Claims
(per $1 million in revenue)

These findings demonstrate that smaller construction companies, with annual revenue under $1 million, had the highest number of liability claims. These companies averaged 5.1 general liability claims. This is nearly three times higher than companies with annual revenue of $1-$5 million, which experienced only 1.9 general liability claims per $1 million in revenue over the last five years. Larger construction companies with annual revenues over $5 million experienced only 0.9 liability claims per $1 million in revenue. These results indicate a trend in the market. Smaller companies typically experience significantly higher levels of liability claims than larger companies. This does not mean that all smaller companies are more likely to experience general liability problems.
But how does this compare with insurance premium growth? If the smaller companies are generally riskier, one would expect that their insurance premiums should have risen more dramatically than those of the larger companies.

**Insurance Premium Increase by Company Size**

To answer the question of insurance premium growth by company size, the study again analyzed all the companies by annual revenue. For this portion, average insurance premium increase was determined according to company revenue. The same categories were used to maintain consistency. The results are as follows:

![Average Insurance Premium Growth](image)

The chart indicates that although smaller companies (with annual revenue of less than $1 million) have the highest liability claim incidence, they incurred the smallest insurance premium growth—only 30%—during the last five years. Companies with $1-$5 million in revenue have seen the greatest increase in insurance premiums—76%. It is also important to note that this category accounts for 46% of companies analyzed in this study. These results statistically support the conclusion that most contractors can be considered lower risk, yet they pay the majority of insurance premium increases.

To more thoroughly demonstrate the impact on the construction industry, we can overlay the previous two charts and compare average number of liability claims against average premium growth by size.
The chart clearly details that construction contractors are not being assessed by their actual liability exposure or their claims experience.

**Settlement Decisions**

It is also important to have an accurate understanding of the outcome of these claims. Findings were analyzed to determine the settlement decisions for the claims that contractors face. The following graph details the three primary types of claims incurred: worker’s compensation, general liability, and automotive, and provides the percentage of each settlement outcome. The following chart indicates that contractors have had little to no success defending themselves against claims made against their business.
Contractors reported having reached a satisfactory outcome in only seven percent of general liability claims and two percent of worker’s compensation claims analyzed in this study. This finding indicates that regardless of claim type or characteristics, contractors are finding that a general mentality shift in claims handling is enabling aggressive plaintiff lawyers to seek unjust or excessive settlement awards. Contractors are finding themselves in an environment where:

- Insurance companies prefer to settle first, despite case details. They are even less likely to oppose the case when the contractor may be partly at fault and where a trial/ruling by the court might establish a precedent perceived by the insurance company as negative.
- Especially where fear of precedent exists, plaintiff lawyers have developed effective techniques to exploit that fear and exact substantial settlements.

**Excessive Awards for Legitimate Claims**

One area examined during the interview process was the disproportionately high level of settlements. A great deal of attention has been paid to ever-increasing amounts awarded to claimants. Contractors revealed that settlements were in excess of any reasonable value even in cases where they felt a legitimate claim existed. The dollar amount awarded for these claims continues to move upward, perpetuating the problem. Moreover, cases where contractors are not allowed to fix the defect in lieu of a court decision are becoming more common. This condition is creating a system where it becomes appealing for building owners to take contractors to court instead of allowing them to remedy the situation.

**Case Example**

Claim amount - $55,000  
Area – Chicago, Illinois

A contractor has been dealing with a case about a construction defect for the last two years. The claim is legitimate, but the building owner will not allow the contractor back into the building to fix the problem. The contractor is frustrated because the estimated cost to repair the job is $25,000 but the claim amount is $55,000. The case has been drawn out for two years and has been a substantial time and money burden for the contractor.
Changes in the Competitive Environment

According to the U.S. Bureau of Labor Statistics, the construction industry employed 5% of the total workforce in 2000, 2001, 2002 and 2003. Clearly, this commanding segment of the U.S. economy is being adversely affected by excessive litigation and rising insurance premiums. Contractors were asked to discuss how the implications from claims and claim-related difficulties have affected their competitive environment. The findings from this portion of the study indicate that many contractors have seen an evolution in the way their markets function.

The problems caused by excessive litigation, dramatic price increases and the inability to defend against claims are forcing construction prices upward.

Figure 11

Type of Changes in the Competitive Environment
(As A Result Of Increased Insurance Premiums)

- 40% Decrease in the Number of Companies Willing to Write Policies
- 36% Unable to Afford Wages or Cover Benefits
- 24% Other*

* “Other” responses are reported on the following page
The most prevalent impact is that many firms are operating with insufficient levels of insurance coverage. This issue must be addressed because it hurts responsible contractors and the reliability of the industry as a whole. This is a critical finding and underscores the importance of ensuring adequate insurance coverage for the construction user.

Contractor verbatim:

“We have been in business for over 100 years. The problem with low quality work or insufficient insurance is that smaller companies can just close up shop when problems arise and open under a new name. This hurts us tremendously because we have to compete with these companies and it puts us at a disadvantage.” – Illinois

**Hypothesis #4 – Valid**

*The study has verified that several changes in the contractor environment have impaired contractor ability to pursue normal business activities. Some companies are better equipped to deal with these shifts, but all companies are negatively impacted by uninsured and underinsured competition.*
Managing the additional costs associated with rising insurance premiums has been a critical area of attention. Contractors were asked to share the ways in which they try to manage these costs. In the long-term, costs must be passed on to customers as a project expense. This ultimately results in significantly higher construction costs. However, in the near-term, contractors must absorb some of the insurance premium increases. They cannot pass on the full burden to their customers in fixed price construction contracts. Respondents of this study report that approximately 65 percent of the increased costs have to be immediately passed on to customers. They report that this hurts their ability to be awarded some business and has strained customer relationships. Customers typically don’t realize the level of insurance expense needed to cover the project and feel that the contractors are unfairly trying to increase their margins. This situation has created a communication disconnect between contractors and their customers.

Attempts have also been made to control the resistance to passing costs on to customers. On average, respondents say that 11% of the additional expenses have been absorbed by lowering operating costs. Another 10% of the cost increases have been countered by reducing overhead employees because it is simply too expensive to pay the related insurance to keep them with the company. Other reported cost reduction initiatives included trying to streamline internal processes, lowering employee benefits and salaries, raising deductibles, and moving away from high-risk business.
Implications to the Financial Structure

In the long-term, contractors must pass on insurance price increases to consumers. These passed-on expenses come in the form of higher project costs and provide no additional value to the construction project or the consumer. The following chart demonstrates the significance of insurance premium growth as a percentage of total contractor revenue over the last five years.

Figure 14

Net Income Versus Total Insurance Premium Growth
(As a percent of total sales)

![Chart showing Net Income and Insurance Premium growth]


Study results confirm that total insurance price increases are driving up consumer construction costs. Firm owners shared their concerns regarding a decreased net income in the near-term and drastically rising construction costs in the long-term. Many owners have attempted to counter the price increases through operational cost reduction initiatives but have found that most of the efforts provide only minimal relief. These findings provide an accurate snapshot of the industry as it functions today.
Scope of the Impact on the Industry

The construction industry plays a very important role in the U.S. economy. It employs nearly five percent of the total United States work force, representing nearly 500,000 firms, over three million employees, and over $750 billion to the economy.

However, this diverse and broad component of the U.S. economy is being dramatically altered by the current liability insurance situation and increasing tort costs. It is estimated that total tort costs represent approximately two percent of Gross Domestic Product (GDP), or nearly $250 billion. As stated by the Council of Economic Advisers in its Executive Summary of “Who Pays for Tort Liability Claims? An Economic Analysis of the U.S. Tort Liability System”,

“The total U.S. tort cost is more than the Federal government spent on all of the following programs combined: education, training, employment, general science, space and technology, conservation and land management, pollution control and abatement, disaster relief and insurance, community development, Federal law enforcement and administration of justice and unemployment compensation. Viewed differently, at more than 3 percent of wages per year, the cost of the litigation tax is also far more than enough money to solve Social Security’s long-term financing crisis. To a family of average income, this covers the cost of more than three months of groceries, six months of utility payments, or eight months of healthcare costs.”

Tort cost statistics specific to the construction industry are not available, but because of asbestos and mold litigation, they must be significant. As with any tax, the economic burden of the “tort tax” is ultimately borne by individuals through higher prices, reduced wages, decreased investment returns, or a combination of the three. When the volume of new construction, retrofit and maintenance work for both residential and nonresidential construction is considered, the impact of tort costs on construction users (contractors) and taxpayers (consumers, building owners, etc.) is significant.
Construction users:

The negative impact on construction users is widespread:

- Erosion of profit – the construction services industry is low profit to begin with, averaging only two to four percent net profit. Insurance premium hikes and tort cost distribution increase a firm’s costs and erode profit even further.
- Lower wages/ unemployment – though other factors also play a role, the U.S. has seen an increase in the unemployment rate for the past three years.
- Decreased insurance coverage—the inability to get insurance coverage in some key areas increases the risk to both contractors and building owners.
- Adverse affect on small business owners—this important segment to the U.S. economy is significantly affected. Firms with less than 10 employees represent approximately 50 percent of construction industry and overall U.S. employment.

Taxpayers (consumers, building owners, etc.)

Liability insurance has significantly impacted the construction contractor community, but the impact on the taxpayer has been even more significant as increases are passed down the value chain. Incorporating both direct and indirect costs, Ducker estimates that taxpayers currently absorb the burden of **$20 to $25 billion on an annual basis**. This financial burden does not add any value to the finished good or service.

Figure 15
The findings in this report document the significant impact rising insurance costs have on this large portion of the U.S. economy. As discussed earlier, business owners are concerned about the viability of their businesses. Companies are releasing qualified workers because of the associated expense of insuring them. Companies throughout the country are struggling to cope with these issues.

Residential Projects

The United States residential new construction market accounts for $283.3 billion annually. The average residential new construction project costs approximately $10,000 per contractor. According to the NAHB, a general contractor manages eleven subcontractors on a typical project. In 1998 the portion of the project cost attributed to insurance coverage was 2.5% or $250. By 2003 the percent of total project cost required for insurance expense on the same project had increased to 4%, or a total cost of $400. This increase is on a per-subcontractor basis. These cost increases mean that the average new home in 1998 had an insurance expense of $2,750 built into project costs, while homes built in 2003 had $4,400 of insurance expense built into the project costs. This is an increase of nearly $2,000 to every new home that adds no value to the consumer.

The United States reported 1.85 million new housing starts in 2003. With a 50% insurance premium increase on these projects, new home buyers are spending over $6.8 billion a year more in insurance costs to build their homes than they spent in 1998. This amount adds no value to the home, but still must be paid for directly by the consumer. A summary of the impact to the U.S. economy is provided below:

<table>
<thead>
<tr>
<th>Year</th>
<th>Total New Home Construction</th>
<th>Insurance Portion</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>$283.3 billion</td>
<td>$11.3 billion</td>
</tr>
<tr>
<td>1998</td>
<td>$179.8 billion</td>
<td>$4.5 billion</td>
</tr>
</tbody>
</table>

Residential Cost Increase $6.8 billion
Nonresidential Projects

The United States nonresidential new construction market accounts for over $155 billion annually. This market is comprised of commercial, manufacturing and institutional buildings. An analysis of the market size is provided below.

![Figure 16](image)

**Table: 2003 Non-Residential Projects**

<table>
<thead>
<tr>
<th>Segment</th>
<th>Value (Thousands)</th>
<th>Number of Projects</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial</td>
<td>$58,767,000</td>
<td>52,500</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>$6,702,000</td>
<td>3,300</td>
</tr>
<tr>
<td>Institutional</td>
<td>$89,819,000</td>
<td>35,270</td>
</tr>
<tr>
<td>Total</td>
<td>$155,288,000</td>
<td>91,070</td>
</tr>
</tbody>
</table>

According to the McGraw-Hill Construction Dodge Analytics, the average commercial project costs $1.1 million, the average manufacturing project costs $2 million, and the average institutional project costs $3 million. In 2003, the total value of these projects was $155 billion. Following the same analysis used for the residential market, the 1998 total insurance expense for these new construction projects was approximately $3.8 billion. In 2003 the project cost for insurance expense had grown to over $6.2 billion. In only five years, the cost to taxpayers/end users for insurance premiums grew by more than $3.1 billion dollars per year.

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Non-Residential Construction</th>
<th>Insurance Portion</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>$155.3 billion</td>
<td>$6.2 billion</td>
</tr>
<tr>
<td>1998</td>
<td>$154.5 billion</td>
<td>$3.1 billion</td>
</tr>
</tbody>
</table>

Non-Residential Cost Increase $3.1 billion

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U.S. nonresidential consumers are paying $3.1 billion more every year as a result of the construction insurance increases! Again, these are just the direct costs incurred from insurance premium increases. Indirect costs, such as expenses associated with lawsuits, may double this number.

Repair/ Maintenance Projects

New construction is an important segment of contractor business, but retrofit/repair/ maintenance work also represents a significant portion of their annual business. Non-new construction is estimated at $350 billion annually. The 3% “tax” (insurance premium increases) costs contractors an additional $10 billion each year.

The resultant condition is that the U.S. construction industry, its consumers and taxpayers now pay over $20 billion a year more because of insurance premium increases incurred over the last five years. These results are dramatic and present an immediate call for corrective action.

Hypothesis #5 – Valid

Hypotheses 1 – 4 have been confirmed. The implications from these events are dramatically increasing construction prices to consumers by $20 billion annually.
Case Study – Firm A
Contractor Type: Electrical
Association: NECA
Area: Brooklyn, NY
Years in business: 22
Sales Range: $8 million

Insurance Concerns
- Specific concerns include:
  - Prices are way too high. They have gone up significantly two to three times in the last five years
  - The president stated that it has become impossible to find reasonable insurance. The company has had only one claim in the last five years, which is still pending. The insurance has increased more than $100,000 during that period.

Premium Expense
- 1998 = $100,000
- 2003 = $211,000
- This is a premium increase of $111,000 or 110% during the five-year period.

Competitive Environment
- There has been a change in the competitive environment and with their ability to competitively bid on jobs.
- The president stated that they try to build the costs into their bids. However, many times they find they cannot pass on the costs and still remain competitive.
  - We try to stay competitive, which means that much of the time the increased costs have to come out of our profit. We have experienced a big cut in our profit.

Third Party Suit
- The company is involved in a third-party suit that they are trying, with little success, to defend themselves against.
  - I am being sued by a worker from another company who used one of our tools (without permission) and got hurt. Now he is suing me, and my insurance company won’t cover it because they say that I didn’t notify them in a timely manner, even though I didn’t know about the incident until he brought the suit against me.
Case Study – Firm B
Contractor Type: Roofing
Association: NRCA
Area: Spring Valley, CA
Years in business: 12
2003 Sales: $5 million

Licensing Requirements
- Contractor’s license
- Roofing license

Insurance Concerns
- Specific concerns include:
  - There has been an increase every year of at least 20 to 30 percent.
  - My insurance premium has increased 300 percent since 1998.
  - The insurance companies are taking advantage of their customers. The contractor down the street has had 10 claims in the last five years, and I have had one and we pay the same premium.

  The president of the company reports that he believes the only claim they have had is fraudulent. It was a general liability issue that the insurance company settled out of court. He had no success trying to defend against the claim, and he reports that the increase in premium expense has dramatically hurt the business.

Premium Expense
- 1998 = $156,000
- 2003 = $450,000
- This is a premium increase of $294,000 or 300% during the five year period.

Insurance Coverage
- The contractor revealed that many customers won't accept the policy form anymore because they feel there isn't enough coverage.
  - Even though we are paying 300% more for our policy, the insurance companies don't want to give any coverage for all the money. They keep cutting things out of our policy.
  - We have had problems with coverage for mold, asbestos, employee liability and additional insureds.
Competitive Environment
- There has been a change in the competitive environment in this market.
- The president stated that his competitors do not have proper insurance coverage.
- The increase in costs is hurting their ability to bid on projects.

Contract Review
- The company reviews 100% of the project contracts, many with their insurance agent. They also have scheduled quarterly reviews to ensure that they are up-to-date and adequately covered in all areas.

The company has had to pass on much of the increased insurance costs to customers. They have tried to reduce operating costs but are finding it difficult to effectively compete in their market.

Case Study – Firm C
Contractor Type: Plumbing and Heating
Association: PHCC, MCAA
Area: Chicago, IL
Years in business: 40+
Sales Range: $5 – $10 million

Licensing Requirements
- The contractor is required to possess a city license (Chicago proper), but none is required for surrounding suburbs.

Insurance Concerns
- Prices have become a huge concern. Specific concerns include:
  - We have had only three claims in the last five years and all three have been worker’s compensation issues.
  - We had one serious injury in 2000.
  - Our insurance premium tripled in April 2001 and has remained at that level despite quality performance and a good operating record.

Premium Expense
- 1998 = $46,000
- 2003 = $140,000
- This is a premium increase of over 300% during the period
Insurance Coverage

- The contractor has not had a single liability claim yet is finding that few companies are willing to write worker’s compensation insurance. There is increasing difficulty controlling liability insurance.

Risk Transfer

- The contractor feels that general contractors act less like a partner and more like an adversary. He has experienced difficulties which have pitted the general contractor against the subs on projects. This has caused difficulties in the project structure and complicated the overall project.

Contract Review

- The president reviews 100% of the project contracts before engaging in the projects. They also take the contract to their insurance agent whenever they have questions about the language or the contract implications.

Operational Initiatives

- The firm monitors foreman trends, looking at project estimation and performance. This enables them to track their productivity against goals and from year to year.

This contractor has been in business for over 40 years and has a well-established track record in both quality and safety. He is finding that insurance companies previously willing to write policies for them are now turning them down. The implications from insurance premium increases and limited coverage are negatively affecting both the contractor and the market.
CHAPTER 4: IDENTIFIED CAUSES AND DRIVERS OF LIABILITY PROBLEMS
Overview

In addition to internal issues discovered throughout the research process, external market and industry factors must be considered. These factors provide a more in-depth understanding of contributors to today’s problems with contractor liability coverage and rates. By no means mutually exclusive, these factors must be considered collectively to understand not only potential solutions, but also the recommended solutions at the federal, state and contractor firm level.

Figure 17

External Factors: Impact on Contractors

| Insurance Industry Changes
<table>
<thead>
<tr>
<th>External Factor</th>
<th>Impact on Contractor Business</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial and economic cycle</td>
<td>Increased insurance premiums.</td>
</tr>
<tr>
<td>Revised insurance pricing strategy</td>
<td>Greater scrutinization of contractors and drastic changes in pricing, coverage and overall lines of business.</td>
</tr>
<tr>
<td>Catastrophic incidences</td>
<td>Impact the profitability/financial stability of the insurance companies, which in turn impacts pricing strategies/premiums of the insurance carriers.</td>
</tr>
<tr>
<td>Reinsurance changes</td>
<td>Supply/availability problems of reinsurance, which leads insurers to be more selective about the companies they are willing to cover.</td>
</tr>
<tr>
<td>Increase claim per dollar of construction</td>
<td>Increased insurance premiums.</td>
</tr>
</tbody>
</table>

| Increased Tort and Legal Activity
<table>
<thead>
<tr>
<th>External Factor</th>
<th>Impact on Contractor Business</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asbestos litigation</td>
<td>Initial impact was insurance coverage, manufacturer bankruptcies and premium increases. Now plaintiff lawyers are targeting contractors in addition to manufacturers and material suppliers.</td>
</tr>
<tr>
<td>Mold litigation</td>
<td>Potential defendant candidates in litigation, in most cases insured.</td>
</tr>
<tr>
<td>High awards in third party cases</td>
<td>The success of third party in cases grounded in worker’s compensation claims have created a mentality shift/new playing field for plaintiff lawyers to target other areas for litigation.</td>
</tr>
</tbody>
</table>
Insurance Industry Changes

Over the past few years, the overall economics of the insurance industry have changed—insurance companies are losing money, which is causing drastic changes in premium pricing.

The construction industry has experienced dramatic premium increases over the past few years. In fact, insurance premium growth has far out-paced growth rates in the construction industry. The cumulative growth rate chart below illustrates the disproportionate growth of insurance premiums compared to the industry growth rate. Multi-family units have shown minimal growth over the past five years (1.2%). The high level of litigation, much of which is based on dubious construction defect allegations, has made it increasingly difficult for contractors to find coverage for these types of projects. Residential single-family starts have experienced 25 percent overall growth and show signs of continued strength. The need for residential construction will continue, with or without insurance. It is important that insurance companies acknowledge business opportunities in residential construction instead of continuing an environment in which construction users are exposed to uninsured and underinsured contractors. This may perhaps only happen with necessary legislation. Otherwise, the current structure will continue to create a burden on all parties. This has added higher construction costs overall.

Figure 18

Construction Activity Growth vs. Insurance Premiums
During the 1990s, commercial lending institutions averaged a 15 percent return on equity while the property and casualty insurance industry (collective term for property insurance, liability insurance and reinsurance) averaged a six to seven percent return on equity. The return on equity for the property and casualty industry has declined each year since 1997.

The property and casualty industry’s combined ratio (losses paid and reserved plus expenses as a percentage of premiums collected) averaged 108 percent in the 1990s and climbed to 110 percent in 2000 and 115.7 percent in 2001 (based on information from the Insurance Information Institute). This means the industry paid out $115.70 for every $100 it collected in 2001. Companies which survived used investment income until the stock market and interest rates dropped. Although underwriting losses are cyclical, the trend is continuing to worsen. The most significant losses have come during the past few years.

Figure 19

**Underwriting Gain (Loss)**

*1975 to 2003*

*Based on 9-month result.*

**Source:** A.M. Best, Insurance Information Institute
Catastrophic events impact the profitability/financial stability of the insurance companies and ultimately affect their pricing strategies.

The two monumental events that most significantly impacted the insurance industry in the past four to five years are the 9/11 terrorist attacks and asbestos litigation (covered in a later section).

The 9/11 terrorists attacks drained the insurance industry, causing at least $40 billion in property damage. On November 26, 2002, the President signed the Terrorism Risk Insurance Act. This act allowed private insurers and the federal government to share the risk of future losses from terrorism for a three-year period. However, the 9/11 losses were primarily absorbed by the multi-national reinsurance companies, which act as insurers of insurance companies. Approximately 70% of the insurance losses lie with reinsurers. The reinsurance industry is critical as it sets the base for insurance premiums. This industry, which still is not making money, is what really drives insurance rates. A restriction in reinsurance capacity has forced construction insurance premiums upward drastically.

\[ \text{Insurance industry financial problems} = (\text{drastic increases in pricing}) + (\text{greater scrutinizing of contractors to be covered}) - (\text{breadth of coverage}) \]

Fluctuations in the financial markets impact the premium pricing strategies of insurance companies. These cyclical financial and economic changes affect the ability of insurance companies to stay profitable. Losses from catastrophic events and significant litigation (e.g. asbestos) have reached astronomic amounts, and insurance companies have had to find other ways to turn a profit. Unfortunately for their customers, this means increasing premiums and excluding coverage areas that continue to drain insurance market profitability.

Analysis of the World Rate-On-Line Index confirms the premium increases. The index indicates increased pricing and decreased limits (though not as much after Hurricane Andrew in 1992). Premium rates have increased significantly since 2000 and are expected to continue.

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8 Excerpts taken from: “9/11 Impact on Insurance Industry”, Speech by Norbert O’Reilly. CIF at The Re-Launch of Contractors Cover on Tuesday, 8th February 2005

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Insurance company financial troubles have caused premiums to skyrocket over the past five years. There are numerous hypotheses about the underwriting cycle and why premiums increase, but most lead to past losses and/or uncertainty:

- Past losses explain current premiums.
- Premiums are efficient predictors of future losses.
- An inverse relationship exists between current premiums and past surplus changes.
- An inverse relationship exists between interest rates and premiums.
- A positive relationship exists between underwriting expenses and premiums.
- A positive relationship exists between uncertainty and premiums.

Research conducted by the Council of Insurance Agents and Brokers (CIAB) supports data collected by Ducker Worldwide – nearly two-thirds of those interviewed by CIAB report premium increases of 10 to 30 percent.
Coverage and contract requirements cause further problems

Anti-indemnity and waiver of subrogation clauses force general contractors to make additional requirements of subcontractors and other providers on the project. This leads to unnecessary complexity in contract language, added commercial expense and a focus on legal protection versus contractor collaboration and valued construction services. The cumulative effect of these additional costs is substantial and absorbed by construction users and tax payers.

Higher premiums are not the only major issue. Contractors also face problems obtaining overall insurance coverage and coverage for specific projects. Insurance companies now use more stringent processes to qualify a contractor for coverage. The availability of insurance to specific contractor trades is decreasing as insurance carriers are increasingly changing their overall portfolios to reduce their risk. Liability insurance capacity is also decreasing—it dropped 20 to 30 percent between 2000 and 2002.

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9 Marsh, 2002 Limits of Liability Report

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**Increased Tort and Legal Activity**

*Increased tort and legal activity in areas such as asbestos, mold, and construction defects and the past successes of worker’s compensation claims have created a monumental shift for all entities of the construction value chain. The general abuse of the tort system has created an ideal environment for growth of mold and construction-defect suits.*

According to a study conducted by Tillinghast-Towers Perrin (Weatogue, Connecticut), the cost of the U.S. tort system has consumed two percent of gross domestic product (GDP), on average, since 1990. This number is expected to continue to increase substantially over the following years. In fact, total tort costs in 2005 are forecasted to reach nearly $300 billion.

![Cost of U.S. Tort System](image)

*Source: Tillinghast-Towers Perrin: U.S. Tort Costs – 2003 Update*
The significant rise in tort costs is based on many variables, some softer than others:

- Cultural – someone must always be held responsible; attorney manipulation of the “system”; class action lawsuits, etc.
- Prior success with worker’s compensation claims - though not directly related to liability insurance, the rising cost and legal activity of worker’s compensation claims in recent years has fueled cries for reform. Many believe that the current system does not work because it 1) promotes adversarial relationships among employers, employees, insurance companies and legal advisers, and 2) causes workplace disruption and unproductive expense. As these costs rise, many employers are seeing a spillover into liability. The plaintiff success in third party suits has set precedence for other areas of litigation.

Asbestos claims, which are specific to the construction industry, have been one of the leading drivers of tort costs. Many believed asbestos-related claims were winding down in the late ’90s, but a large number of claims have re-surfaced in the past few years. However, this time around the playing field is different:

- Plaintiffs’ lawyers have changed their focus/targets from major manufacturers to others in the value chain, which includes suppliers, distributors, building and facility owners, and various trade contractors.
- The majority of claims filed are by plaintiffs who have no signs of illness or injury. Over 50% of compensation has been awarded to claimants with no malignant injuries.
- Many of the manufacturers targeted have filed for bankruptcy protection.
- Cases are migrating from known litigious states to other states.

It is reported that over 600,000 people have filed claims, and more than 6,000 companies have been named as defendants. Total costs range between $200 billion and $265 billion.\(^{10}\)

Many in the industry believe that mold and construction defect litigation could be “the next asbestos” to affect the insurance industry:

- In 2000, mold was not a significant concern – now mold is responsible for over $3 billion in incurred commercial claims. In addition, the impact of mold litigation is fragmented across various states, building types and defendants. The severity and exposure of mold is still unknown, so many insurance carriers exclude or limit coverage in this area.
- Construction-defect claims, which originated in Southern California, are an ongoing concern for insurance companies and impacts all general contractors/builders and sub-contractors. This type of litigation is primarily found in residential construction (particularly tract housing and multi-family housing), but has the potential to expand into non-residential areas.

Mold has been one of the fastest growing litigious areas, fueled by disproportionately high settlements.

![Figure 23: Increase of Mold-Related Claims (Two-Year Period)](chart)

Mold is an ancient problem that has, as of late, made its way into the courtroom with increasing frequency. It is estimated that about 10,000 mold-related lawsuits were filed nationwide in the last three years. Reports of the huge jury verdicts in several high-profile mold cases likely helped fuel this surge.

In June 2001 a Texas jury awarded homeowner Melinda Ballard over $32 million in damages (reduced to $4 million) against her insurer for mishandling mold related claims. In June 1996 a Florida jury awarded Martin County, Florida over $14 million against its construction manager and sureties for the defective construction of the county’s courthouse and office building that led to mold contamination. In 2000 insurers paid approximately $200 million toward mold claims. That number shot to $1 billion in 2001 and a staggering $2.5 billion in 2002. According to the Insurance Information Institute, the average residential mold claim costs about $35,000 and can easily exceed $100,000. These numbers suggest that the cost of a mold inspection, which ranges from $300 to $1,200 depending on the size of the building, would be money well spent. Mold claims have cost insurers so much that they have successfully lobbied 35 states to allow them to exclude coverage for losses caused by mold.

12 The Fungus Among Us: Mold Litigation and Liability. Poyner & Spruill, LLP
As reinforced by Kathy Woodliff in *Professional Roofing* magazine:

“The risk of construction-defect litigation greatly increases with the convergence of the following primary factors:

- **Lack of construction quality** – adequate training, supervision and quality control mechanisms are not in place.
- **Physical environment** – there are two primary loss causes in construction – defect litigation and soil issues, such as subsidence and water intrusion. One or both of these factors usually are alleged to have occurred continuously over a long time period.
- **Complex litigation** – the primary focus is residential properties with homeowners’ associations where the economic incentives for plaintiff firms are much higher.
- **Case law and statutory requirements** – a long statute of repose period occurs because of:
  - the latent nature of claims
  - policy coverage interpretation for damages is too broad
  - strict liability standards instead of proportionate liability standards for the construction of homes are employed in some jurisdictions.
The figure below illustrates how the average number of product liability jury awards between 1994 and 2000 grew by 300 percent. Today, the states with the most construction-defect litigation are reportedly Arizona, California, Colorado, Nevada, Oregon, Texas and Washington. Many of these suits occurred because of the significant growth in construction activity in past years and the more litigious nature of some states.

**Figure 24**

**Average Jury Awards**

1994 versus 2000

These external factors clearly show that the construction industry needs to support tort reform. The issues driving the liability crisis do not exclude the contractors, but these external forces are areas in which the contractor has limited control.

**Hypothesis #3 – Valid**

Secondary data supports the hypothesis that claims frequency is increasing dramatically. Information obtained from contractors and data on the number of claims being filed conclude that contractors are largely defenseless to protect themselves against mounting litigious action.
CHAPTER 5: CONCLUSIONS AND RECOMMENDATIONS
Overview

The findings of this comprehensive research project show that a solution to address liability availability and cost is needed throughout the U.S. construction industry. This industry and its members are critical to our nation’s economic and employment prosperity, and this issue is serious enough to require attention by our governments and the insurance industry.

Many solutions have been proposed or implemented in an attempt to achieve better overall coverage and cost. Research indicates that state legislation has been effective addressing tort activity in the construction industry. Various groups working with the insurance industry note a greater focus by insurers to work with contractor customers to achieve proper coverage. Individual contracting firms look to advance in the areas of insurance company partnership, coverage and overall negotiation.

However, our expertise in construction markets and the critical legal and insurance research conducted for this study indicate the most effective solution program combines federal, state and firm initiatives.

The analysis in this section defines potential solutions and actions that can be implemented across different segments of the industry by different constituents. Specific tort reform measures are profiled. Also presented is a defined analysis of grouped insurance programs that may not be an appropriate solution. In the end, it is the combination of tort insurance industry reform efforts at multiple levels that will drive industry change and positively affect liability insurance cost and impact.
Recommendation #1- Federal Tort Reform

The construction industry is a healthy growing segment of our national economy and a solid base of employment. A record level of residential and nonresidential construction projects has been completed by many contractor trades. The construction industry represents $750 billion in revenues and consistently contributes to the economic value of our country.

The construction contracting industry is primarily comprised of small businesses which operate in local markets and contribute to local communities. According to the Institute of Legal Reform, approximately 68% of total tort claim costs are absorbed by small businesses with revenues under $10 million. Average contractor profit is only two to five percent, and businesses struggle to deal with the financial burden. To remain viable, they must pass this burden on to their customers. The end result is that $20-$25 billion in expense is passed on to users of residential and nonresidential facilities, yet no value is added to the finished product.

Further, state legislative and case activity indicates the need for a consistent, federal standard regarding liability and legal processes. The main focus of federal action must center on tort reform.

Research has determined that a broken tort and legal system is the cause of these problems and expenses.

Much of today’s reform occurs at a state level. But a federal responsibility exists to place pressure and provide guidelines that support improvements to the tort system. In fact, industry experts and historic independent studies indicate common law and state-governed legal systems have not kept an appropriate balance and allow for abuse by entrepreneurial law firms.

It is in the best interest of our federal government to determine methods to address the insurance problem affecting our contractors and the national economy. Federal action is appropriate due to the interstate commerce activity of large insurance companies and elements of the construction industry itself. Numerous benefits will occur, including measured productivity gains and cost reductions for construction users.
National Bureau of Economic Research Study # 4989

This important study developed a model to determine the correlation of select drivers and outcomes for liability reform and provided the following conclusion:

Reduction in liability levels is associated with increases in productivity (7-8%) and employment (10-20%)

Analysis of Economic Impact of Tort Activity

This analysis indicates that the increasing tort activity is inefficient and costly to the nation’s tax payers and economic cycle.

Therefore, federal and state tort reform is necessary and will provide economic, productivity and employment benefits.

The sponsors of this study and a coalition of other contractor groups should immediately pursue pending legislative action in Congress regarding tort reform and explain its importance to the construction industry and its stakeholders. Federal attention to the issue will help highlight the need for change in our tort system. The construction industry is important and should be included in existing reform efforts that include:

Support Legislation Regarding Tort Reform:

The overwhelming financial benefits provided by our existing tort system are what make it so attractive to our legal community. The following measures, when supported by federal legislation, will provide a better measure of justice, reduce excessive financial gains in the legal community, and create a less attractive environment for frivolous claims.

1. **Limit non-economic damages (i.e. punitive awards)**
   The growth in size and frequency of non-economic damage awards contributes greatly to the current problem and attracts frivolous tort activity.

2. **Eliminate Collateral Source Rule**
   The existing rule prohibits evidence that shows that plaintiff losses have been compensated by other sources.
3. **Replace Joint and Severability with Proportionate Liability**

The existing joint and severability rule allows for a defendant who is least liable to be responsible for the entire judgment award when co-defendants are unable to pay. A proportion rule allows for each co-defendant to be liable for only his/her share of damages – as determined by the court.

4. **Allow Periodic Payment of Fees**

This allows damage awards to be paid out over time. It does not eliminate or reduce damage awards; it provides a reasonable period of time for payment, typically arranged with an initial payment and a structured annual payment for the balance.

In addition, contractor associations should continue to support and become involved in The Lawsuit Abuse Reduction Act (LARA), pending House Bill HR420. This Act aims to reduce frivolous lawsuits and forum shopping of injury claims by imposing sanctions on attorneys filing lawsuits that do not meet case qualifications. This act will reduce construction tort activity for both residential and nonresidential construction.

According to the Lawsuit Abuse Reform Coalition, the LARA will:

- Restore mandatory sanctions on attorneys, law firms, or parties who file frivolous lawsuits;
- Abolish the "safe harbor" provision, which allows parties and their attorneys to avoid sanctions by withdrawing a suit within 21 days after a motion for sanctions is filed;
- Permit monetary sanctions, including reimbursement of reasonable attorney's fees and litigation costs, in connection with frivolous lawsuits;
- Restore the opportunity for sanctions for abuse of the discovery process (the process by which lawyers on each side of a case request information from the other side prior to trial); and
- Extend Rule 11's provisions, which prevent frivolous lawsuits from applying to state cases in which a state judge determines the case affects interstate commerce (by threatening jobs and economic losses to other states).
LARA provides a national solution to end unjustifiable forum shopping and stops litigation tourism. It does so with equity and justice. LARA allows a plaintiff to file a personal injury case:

- Where he or she resides at the time of filing;
- Where he or she resided at the time of the alleged injury;
- The place where circumstances giving rise to the injury occurred; or
- Where the defendant's principal place of business is located.

LARA precludes plaintiffs' lawyers from filing cases where their clients have no meaningful connection.

Recommendation #2 - Insurance Industry Review and Partnership

Constant changes in the general liability insurance industry over the last 20 years demonstrate a need for the construction industry to provide a constant source of information about contractor liability. The aggressive legal community and the excessive damage awards cloud the facts of true liability cases. The lack of concrete information affects insurance industry evaluation, leading to cancelled coverage or drastic rate increases.

The long term feasibility of a national program has proven to be limited. Efforts and resources should be devoted toward working with insurers to develop and manage effective coverage alternatives over time. Some important actions include:

- Lobby the insurance industry to help it understand contractor business concerns and financial opportunity.
- Work with states to attract admitted (state fund contributing) insurance companies.
- Support legal reform.
- Support the recovery of the reinsurance industry.
- Participate in the development of training programs by insurance groups for contractors.
- Leverage company safety records to encourage further improving the safety of the industry as well as using this as a component of determining insurance rates.
- Join contractors to lobby the construction user community to eliminate unreasonable hold harmless clauses, additional insured requirements and waiver of subrogation requirements in favor of coverage through OCP and PMPL policies.
Join contractors to lobby the construction user community in favor of balanced allocation of risk to the party that controls the risk.

Join contractors to lobby the construction user community to take contractual responsibility for proper post-construction operation and maintenance, thus carrying its fair share of responsibility for Owner transgressions that are presently thought of as the consequences of “construction defects”.

Carefully Examine Combined Insurance Programs

Owners and Contractors Protective (OCP) Liability Insurance

Owners and Contractors Protective (OCP) coverage is typically provided using ISO form CG 00 09. This specifically tailored insurance product, when issued by a contractor or subcontractor, covers the recipient(s) but not the policy purchaser against claims arising out of the operations of the policy purchaser or relating to the owner’s (or contractor’s) “general supervision” of the project. For example, OCP coverage includes defense of “third party over” claims asserted by contractors’ and subcontractors’ injured employees alleging inadequate supervision, such as the owner’s failure to maintain a safe workplace. However, OCP provides no coverage to owners (or contractors) for their operational negligence (as opposed to “general supervision” of the operations of others) such as an injury caused by the careless operation of a front loader by one of their own employees.

Any allegation in a lawsuit of a supervisory failure, even if combined with allegations of the owner’s active negligence, would trigger coverage. OCP insurance furnished by the contractor to the owner protects the owner but affords no coverage to the contractor. OCP insurance by a subcontractor protects both the owner and contractor, but not the subcontractor. Thus, contractors customarily obtain backup coverage from their subcontractors when furnishing OCP insurance to an owner. A specific endorsement is available to add architects and engineers as insured under OCP except for their professional liability. Costs incurred defending and paying damage claims against owners and contractors under OCP policies do not adversely affect the policy purchaser’s loss experience ratings. The coverage is always primary and excess over other insurance available to the OCP insured, so it must be exhausted before the owner’s, contractor’s or subcontractor’s CGL policy is reached. OCP provides separate limits for an insured party whereas an additional insured entity must share the limits with all other insureds. However, OCP excludes coverage for most completed operations.
The PMPL insurance product is similar to OCP, but with some added benefits for contractors and subcontractors. However, PMPL suffers from limited availability. PMPL is a single policy offering primary coverage for the owner, contractor and architect, including subcontracted operations of the contractor. Because the contractor is one of the named insureds, he is spared the need to obtain backup coverage from each of his subcontractors. PMPL eliminates redundancy of coverage and uncertainty about which insurer is responsible to defend an individual claim. The coverage also minimizes legal costs by providing a common defense for two or more defendants, and claim costs do not adversely affect the contractor’s experience rating. PMPL excludes losses caused by a named insured’s operational negligence, and it does not cover completed operations. This targeted insurance product has yet to receive widespread use but it has become more readily obtainable through use of ISP (Form CG 31 15).

In addition to enabling a solution to the additional insured problem, it is necessary for construction industry associations to work together to accomplish the following:

**Provide Insight and Education**

The insurance industry operates on data and models. Without the appropriate or accurate set of data, the output could be misleading or will misrepresent the actual risk involved. Insurance companies need a consistent source of reliable metrics regarding contracting businesses from contracting industry groups, not from case study law or review of judgment activity.

It is also important that insurers become very familiar with the nature of the contracting business, its quality and efficiency position as well as safety measures. The combination of annual training and extensive product quality and job site operations is not fully understood by the insurance industry.

Overall, contractor association groups need to combine efforts to proactively educate the insurance industry about member operations. They need to become a reliable, valid source of information.
Partner with Insurance Industry to Advance Training

Research indicates that contractors who commit to training and education programs about risk, process and overall liability improve their overall business, including areas of insurance. Select insurance agencies with significant construction contract business have developed innovative and effective training sessions. Construction contracting owners indicate this is a valuable tool that offers great insight and value. The associations should strive to support and aid in the development of specific training programs that reflect current changes to insurance policies, limitations and financial considerations.

Lobby with Insurance Industry for Legal Reform

The insurance industry can also directly benefit from tort reform and the restricted use of hold harmless by experiencing a reduction in overall claims and need for settlement. Solutions such as giving a contractor an opportunity to repair and imposing limits on attorney fees will drastically cut down the amount of legal activity and its corresponding impact on insurance policy and finances. Together, the insurance industry and construction industry can present a solid case regarding tort reform and its benefits.  

Continue to work on contract language

Construction associations should continue to work together to improve contract language. Improvements are needed to increase clarity and correctly assign responsibility and coverage that accommodates the special circumstances with subcontracting. Today’s contractual environment with unreasonable hold harmless clauses, additional insured requirements and subrogation are onerous and challenging, except to those in the plaintiffs’ bar, who capitalize on the opportunities these documents create. The industry should work together to reduce the complexity of contracts by addressing the additional insured and waiver of subrogation requirements. This will create a construction environment of collaboration and construction performance that benefits owner and contractor alike. Collaboration with the design professional organizations, code bodies and general and subcontractor groups is necessary to create model contract language with meaningful detail applicable across organizations and projects.

Recommendation #3- State Tort Reform

While federal action is necessary, it is not the single solution of tort reform. Federal efforts to provide guidelines and commonality in reform will allow states to pass legislation with less complexity and greater efficiency. State action is important and must continue to advance legislation in several areas of tort reform where none exists today. For instance, indemnity issues vary by state and one opportunity for the construction industry is to reduce the complexity of contracts and create a more collaborative environment. Tort reform will help, but efforts at the state level may also be required. Several important legislative actions and areas of legal reform can be implemented to reduce the “attractive” environment for legal action and create a more balanced approach to justice for general liability cases. The table on the following page provides an overview of these items.
### Suggestions: Balanced Approach to Justice

<table>
<thead>
<tr>
<th>Options</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Statute of Repose</td>
<td>Provides a time limit for when a lawsuit can be filed. For instance – a statute of repose of 10 years means a contractor cannot be sued for a claim after year 10. This is similar to a statute of limitations and should be 10 years or less.</td>
</tr>
<tr>
<td>Notice and opportunity to repair</td>
<td>Requires home and building owners to provide written notice (often 60-90 days) prior to filing a lawsuit alleging a construction defect. Contractors can then respond, inspect the issue and repair, provide payment or dispute charges.</td>
</tr>
<tr>
<td>Limits on damages</td>
<td>Provides a maximum level of awards to plaintiff for damages incurred.</td>
</tr>
<tr>
<td>Limits on attorney fees</td>
<td>Provides a limit of dollar or percentage terms for attorney’s fees for certain lawsuits and settlements. This is a critical tool that helps reduce the frequency of frivolous lawsuits driven by the legal community.</td>
</tr>
<tr>
<td>Periodic payment of fees</td>
<td>Allows the defendant to pay damages over a period of time.</td>
</tr>
<tr>
<td>Qualifications for negligence</td>
<td>Provides strict guidelines and qualifications a plaintiff must meet in order for a negligence case to be filed or allowed.</td>
</tr>
<tr>
<td>Change from joint and several liability to proportional liability</td>
<td>Known as the “deep pocket” rule – Joint and several liabilities indicates each defendant is responsible for the entire amount of damages. This is financially lucrative to plaintiffs and lawyers, providing incentive for significant tort activity. Proportional liability is a balanced solution that ensures defendants are responsible only for their share of the damage caused.</td>
</tr>
<tr>
<td>Limits to hold harmless</td>
<td>An agreement that one party will not hold the other party responsible. Often combined with indemnification clauses, this policy does not accurately reflect the balance of risk or allow for proper allocation of responsibility.</td>
</tr>
<tr>
<td>Limits on double recovery</td>
<td>Does not allow a plaintiff to obtain the same damage awards from two different sources (typically insurance companies).</td>
</tr>
<tr>
<td>Contributory/Comparative negligence</td>
<td>This allows the inclusion of the plaintiff’s own negligence or acts that contributed to the problem, thus reducing total liability. It is not a complete defense, but often serves as a more just balance.</td>
</tr>
</tbody>
</table>

A review of case studies in states with select tort reform measures similar to those listed above shows lawsuits in these states have more reasonable outcomes and a better representation of justice.
Case Study Example:


- A PennDot state highway construction project in Philadelphia was in process, and the principal/general highway contractor hired a subcontractor, to manage traffic during the removal of highway signage.
- During this stage of the process, a motorist, Greer, was involved in an accident (rear-ended) and became a paraplegic.
- In advance of the project, the subcontractor negotiated specific language regarding indemnity that limited negligence to its own acts or omissions – not full risk or indemnity for all involved.
- The subcontractor was not required to indemnify PennDOT, Philadelphia, or the general contractor!
- The jury held the subcontractor, 22% negligent, the general contractor 22% negligent, Philadelphia 22% negligent, PennDOT 22% negligent, and Greer 12% negligent.

-Brief by American Subcontractors Association, Inc., 2003-05

While many states have implemented some, but not all, measures listed above, it is likely that proactive support and introduction of these efforts will further improve the legal environment for general liability and have a positive impact on claims.

1. **Recommended Minimum Combination of Reform at State level**

The first step in a state tort reform strategy is to pursue states with little reform measures in place and pursue reform through legislation. Using the analysis by state listed above, the priorities are clear. However, not all reforms can be introduced or passed at the same time. A coordinated strategy that builds from existing federal reform efforts (damage limits, collateral source rules, proportionate liability and periodic fee payments) will not duplicate efforts. Analysis of successful tort reform measures in select states indicates the most pressing need is to establish a system that first validates a claim. This process of validation includes notification, timing and the right to cure.

**Statute of Repose**

- Most states today have a statute of repose for construction defect claims. For those that do not, legislation should be introduced immediately.
- Timing limits range from 4 years (Tennessee) to 15 years (Florida). Analysis indicates a maximum of 10 years or less is suitable and reasonable.
For states that have statutes beyond 10 years, legislation should focus on reducing the timeframe to 10 years or less.

**Notice and Opportunity to Repair (Right to Cure)**

- “Right to cure” legislation benefits not only specialty contractors but also general contractors and builders. A collaborative effort with these groups to develop a state lobby program is recommended.
- Many states do not have notice and opportunity to repair clauses. An analysis conducted in 2004 indicates approximately 24 states have legislation active or pending regarding this issue.
- A right to cure legislation program should include notification within 60 days prior to filing a claim, inspection and right to repair or payment, and ability to dispute and defend.

Several other legislative opportunities exist as previously illustrated. Reform measures that address the lucrative aspect of tort activity such as damages, payment process and double recovery can directly reduce the attractiveness to the aggressive plaintiff bar.

**Recommendation # 4 - Contractor Actions**

Tort reform and insurance industry partnership will help create a favorable environment for general liability insurance, but alternatives exist for individual contracting firms to take action to help contribute toward developing a sustainable solution. Each contracting firm is unique based upon its business model, applications served and financial condition. Therefore we offer the following options, and contractors can select and combine those that best fit their businesses.

**Review Contracts and Project Related Concerns**

- Conduct a project review and benefit assessment. This is an effective countermeasure to assess each project for the risk-to-reward benefit and determine if it fits into your business situation. If the risk outweighs the revenue or other benefit, it may not be wise to pursue the project.
- Perform a detailed, legal review of specific project conditions, contracts, and insurance documents to understand true limitations and areas of risk.
- Educate owners and principals about actual risk, quality initiatives by contracting firms, risk management policy, and critical flaws with select policies or contract language that can impact their risk position.
Select legal counsel with expertise and experience in construction-related business and small business activity.
Examine additional insured contracts and the impact on general versus subcontractor liability.
Negotiate or discuss with customers the addition or inclusion of alternative dispute resolution such as arbitration clauses.
Participate in legal and insurance industry training sessions.

**Increase Communication and Documentation**
- Create reliable and consistent data regarding insurance and risk matters that include projects, performance, and claims activity.
- Provide reports to insurance providers and associations to represent the truth regarding actions, performance and risk.
- Create an open dialogue with construction end users and peers for project contract details and risk management programs.
- Identify improvements and document changes to risk management programs and their effects on business.

**Investigate Insurance Program and Strategy**

It is extremely important that contractors know the financial position of the insurance underwriters and review the underwriter’s financial rating. Insurance companies assign risk to individual contracting firms, and contractors should do the same for the insurance companies. Contractors want to be with a company that is at least an A or A+ rating. Anything lower, including A-, is a sign of financial weakness. Sources like the S&P ratings and A.M. Best provide invaluable sources of information concerning an insurance company’s:
- Financial stability
- Growth potential
- Market coverage
- Other important indicators of business health

Some additional creative solutions have been suggested (mainly combined insurance programs to help provide adequate coverage for contractors who work together on a job). However our analysis indicates these programs require significant planning and operational change in order to meet program requirements.

**National Insurance Program Feasibility**

At times when insurance rates and coverage are at a crisis, the issue of national insurance or pooled insurance programs is offered as a viable solution. The purpose of these programs is to combine or
aggregate various contracting firms’ general liability risk in exchange for better rates and coverage, assuming that the volume of the combined groups offers economies of scale.

An analysis of two attempts to create a national or regional insurance program provides valuable insight into this solution’s effectiveness. The first was developed and managed by the National Electrical Contractors Association (NECA) itself through the 1980s and mid-1990s. The second is a private billion dollar investment firm of which confidentiality prohibits public release of results. But interviews with personnel provide important conclusions.

Typically, national programs are formed when insurance costs are at their highest and coverage is limited. These two situations typically occur when insurance investments experience poor financial performance.

Two major conditions must be met for this objective to be accomplished:

- Contractors must maintain or reduce the number of claims from the time the policy is first written.
- Insurance industry investment performance and competitive forces must remain constant.

The combined insurance program adopted by NECA as well as analysis of other grouped insurance programs indicates these conditions are very difficult to meet. In fact, contracting firms have left group programs due to:

- Rate increases at the expense of other firm actions (similar to issues experienced prior to group program).
- Better rates were observed outside the group program (due to competition and insurance industry recovery in local markets).

Due to the advantages and drawbacks of these programs, contractors need to ensure that they are familiar with and have an understanding of the potential implications associated with their involvement in these programs.

***

This concludes our Final Report.

Thank you.

DUCKER WORLDWIDE

Contractor Liability and Insurance Assessment
July 2005 DRAFT
Appendix A: Review of Methodology

Methodology

Ducker uses a five-stage process to assess and improve a client’s business model. The process must be comprehensive, simple, actionable and not artificially complicated. The goal is to aid in accurate and rapid dissemination to accelerate the achievement of results!

1. 2. 3. 4. 5.

Ducker begins a typical program with a situation assessment, or internal audit, during which we develop a common understanding of the client’s current product and service offering and strategy as well as a comprehensive understanding of the industry dynamics affecting the situation. This is followed by comprehensive primary research of the external market(s). Our experience in primary market research and our principle that objective research results are the foundation for developing and improving strategies and business plans has helped many clients achieve growth and profit goals.

With respect to primary market research, Ducker has conducted industrial market intelligence studies since its founding in 1961. Industrial clients have utilized Ducker to discover profitable market opportunities and develop sustainable competitive advantages. The breadth and scope of Ducker’s network of respondents has grown continuously over the past 40 years.

The methodology/approach resembles investigative reporting by professionals with product and service experience. It is true that not all respondents are willing or able to provide the necessary inputs for a complete analysis – therefore, Ducker recommends the triangulation of multiple data points until consistency in response transforms data to information.

To acquire an accurate industry assessment and plan for action, Ducker implements the triangulated approach to ensure accuracy of information along all lines and relevancy to intended recipients.
Information collection for this project is representative of the following model:

**The Importance of a Model**

To approach the process for understanding actual market dynamics for contractor insurance expense, numerous factors must be considered and multiple data points verified. Due to regional discrepancies in all contractor types and markets, insurance and litigation considerations exact vastly different impacts. Factors such as region, firm size (employees and sales), firm performance, residential vs. commercial focus, local and state regulations, quality and claims experience, etc. are important and must be considered in the equation for analysis. To address these issues, Ducker Worldwide has developed a comprehensive model for accurate representation of contractors at the national level with appropriate consideration for regional differences. This model is a unique and proprietary tool that divides data points along nine regional areas and integrates quantitative and qualitative research findings to detail the current situation and highlight areas for implementing change.
Data Collection

The study is centered on in-depth primary market research coupled with a current knowledge base of various multiple building markets. In-depth interviews using both qualitative and quantitative questioning techniques provided the foundation of the market situation estimates and overall dynamics. In total, approximately 300 interviews were conducted with contractors in all groups under study. In addition, we have built and maintained a network of contacts within insurance agencies and various other risk assessment and insurance expense professionals that add value and an overarching perspective to the core of knowledge developed from the contractor interviews.

This approach results in a weighted impact model that includes data input combining available statistics and averages obtained from primary research process. The model is representative of contractor characteristics on the national level with detailed findings and actionable recommendations with regional specificity.

Project Timeline

Project milestones are detailed in the following table:
<table>
<thead>
<tr>
<th>Task</th>
<th>September</th>
<th>October</th>
<th>November</th>
<th>December</th>
<th>January</th>
<th>February</th>
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<tbody>
<tr>
<td>Develop Research Protocol</td>
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<tr>
<td>Electrical Contractors</td>
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<tr>
<td>Contractor Liability and Insurance Assessment</td>
<td></td>
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<tr>
<td>Preliminary data entry, tabulation, information analysis and review</td>
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<tr>
<td>Model and solutions analysis</td>
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<tr>
<td>Preparation of potential remedies, prioritized and impact analysis</td>
<td></td>
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<td></td>
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<tr>
<td>Update Presentation at NECA Meeting</td>
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<tr>
<td>Revisions and adjustments</td>
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<tr>
<td>Final product delivered</td>
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</tbody>
</table>

**Contractor Liability and Insurance Assessment**

July 2005 DRAFT
Appendix B: Summary of Respondent Base

The segmentation chart demonstrates the proportion of each trade classification's inclusion in the study. Finishing and mechanical contractors both joined the project in late 2004 and were subsequently included in the data gathering portion. Representative companies from those two associations join the original seven groups and are captured below in “other”.

<table>
<thead>
<tr>
<th>Business Focus Segmentation</th>
</tr>
</thead>
<tbody>
<tr>
<td>General 10%</td>
</tr>
<tr>
<td>Other 4%</td>
</tr>
<tr>
<td>Electrical 33%</td>
</tr>
<tr>
<td>Air Conditioning 10%</td>
</tr>
<tr>
<td>Sub-contractor 9%</td>
</tr>
<tr>
<td>Plumbing &amp; Heating 11%</td>
</tr>
<tr>
<td>Utility 9%</td>
</tr>
<tr>
<td>Roofing 14%</td>
</tr>
</tbody>
</table>

<table>
<thead>
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Contractor Liability and Insurance Assessment
July 2005 DRAFT
2002 Sales Segmentation

Average: $3.2 Million

Note: Extreme high/low data points were eliminated
Appendix C: State Regulations and Changes

Ducker has performed an in-depth analysis on a state-by-state basis to determine the key drivers in each market. In many cases, laws are tipped so unfavorably to the side of the plaintiff that filing an inflated suit becomes an attractive option. A broad level analysis has been utilized to identify over-arching trends. Individual state analysis was then performed to provide particular relevance to contractors in each market. The following table is a compilation of state-by-state adoption of international codes. The table lists the state’s level of adoption, as well as any special considerations discovered during the analysis.

International Building Code

A building code is the minimum acceptable standard used to regulate the design, construction, and maintenance of building for the purpose of protecting the health, safety, and general welfare of the building's users. Modern building codes rely more on measurable performance rather than in the rigid specification of materials and methods.

In 1994, Building Officials and Code Administration International, Inc. (BOCA), the Southern Building Code Congress International, Inc. (SBCCI) and the International Conference of Building Officials (ICBO) combined the code to form the International Code Council, which later released International Building Codes. These codes are consensus documents that have input from leading technical experts in their fields as well as from enforcement personnel and the product industries. Each change to the codes is submitted and reviewed by all participants prior to approval. As a result, many states that are adopting International Building Codes are getting advanced and updated regulations that improve construction practices in general.

Adequate statewide building code enforcement plays a vital role in public safety and loss prevention. These codes tend to reduce the need for public disaster aid, promote consistent guidelines for design professionals, contribute to the durability of structures and help to decrease construction defects litigation.

The International Code Council (ICC) reports that 44 states (see following table) use International Residential Code (IRC). This demonstrates the rapid rate at which states are updating their codes to try to improve local construction practices. Stronger International Building Codes are recognized as more cost-effective in the long run since they allow construction companies to save money on the post-completion structure repair and construction defect litigation process.
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X Denotes effective statewide
O Denotes state where reform was struck down as unconstitutional and no additional reforms have been enacted
+ Denotes state where appeal bond is not required for a defendant to appeal a decision.

No warranty for accuracy; not legal advice

This chart is intended for informational purposes only and should not be relied upon in the transaction of business
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<td>X</td>
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</tr>
</tbody>
</table>

X Denotes effective statewide
O Denotes state where reform was struck down as unconstitutional and no additional reforms have been enacted.
+ Denotes state where appeal bond is not required for a defendant to appeal a decision.

No warranty for accuracy; not legal advice
This chart is intended for informational purposes only and should not be relied upon in the transaction of business.